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05-US-115

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TELECOMMUNICATIONS DIVISON

September 26, 2002

Ms. Lynda Dorr, Secretary
Public Service Commission of Wisconsin
P.O.Box 7854
Madison, Wisconsin 53707-7854

In re: Docket 05-US-115 relating to Accounting Treatment for Patronage Capital of Telecommunications Cooperatives. Comments in answer to question 1 of the August 26 Notice Requesting Comment.

Dear Ms. Dorr:

My name is Robert Cropp. I am a professor of agricultural economics within the Department of Agricultural and Applied Economics, and Director of the University of Wisconsin Center for Cooperatives, both at the University of Wisconsin-Madison. For better than 36 years with the University of Wisconsin System I taught courses in, conducted research and provided extension/outreach programs directed at cooperatives, marketing and agricultural policy. More specifically with cooperatives I provide training for boards of directors, employees and managers, assist cooperatives with strategic planning, equity capital management, cooperative taxation, and manager appraisal and evaluation.

It has come to my attention that the Public Service Commission of Wisconsin (PSC) has proposed to classify "patronage capital" of telecommunication cooperatives as "additional paid-in capital" by members of the cooperative. This proposal not only is inconsistent with long standing operating principles of cooperatives established by both state and federal cooperative and tax laws, but also jeopardizes the major source of equity capital for these cooperatives. Classification as additional paid-in capital would establish a new form of contribution of capital by the members to the cooperative (since telephone cooperatives do not issue stock.) In this case, the additional paid-in capital would go to the utility part of each cooperative, and become unavailable to the elected board for investment in other activities to serve members. The utilities should not need this capital, because their rates by definition recover their costs, including reasonable levels of capital

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for investment in plant. It is up to the Board of directors to decide whether the return of equity to members, or reinvestment in new services (most likely some of both) is appropriate.

The widely accepted definition of a cooperative is stated as follows, "A cooperatives is a business owned by its users, controlled by its users with benefits accrued to the users according to use or patronage". The ownership implies that members have the responsibility to provide necessary start-up equity capital and to provide operating capital to maintain and grow the business. This equity capital requirement should be in proportion to individual member's use or patronage of the cooperative. Control implies that cooperatives are controlled by the members on a democratic basis, usually on the basis of one-member-one vote as required under Wisconsin cooperative law. And then benefits accrue to individual members in proportion to their use or patronage of the cooperatives. These benefits are from the goods and services offered by the cooperative and from the return of profits (net income, net savings, net margins) to individual members in proportion to use or patronage of the cooperative.

Members of cooperatives provide equity capital as direct investment, retained patronage refunds, or from the sale of common and preferred stock. Direct investment normally provides a relatively small amount of the equity capital needed for telephone cooperatives. Telephone cooperatives rarely if ever sell stock. Instead a membership fee is sometimes collected, but even that has become uncommon. The sale of preferred stock is not commonly used even by other cooperatives because state law restricts annual dividends to 8% or less and dividends paid are not treated as a business expense from either state or federal tax laws. The dominant means of obtaining equity capital is through retained patronage refunds. It is important to note that when the refunds are paid to members, the "patronage refund" (or whatever term is used) is actually a **price adjustment** on the member's earlier business with the cooperative. It is not "dividend income" on an investment, in the traditional, corporate sense. Equally important, the pay-out of patronage refunds is reported as an exclusion from taxable income of the cooperative.

By state law, the elected board of directors has fiduciary responsibilities to make sure the cooperative is adequately capitalized and to establish and monitor financial standards that protect the equity capital provided by members. In this capacity, annually at the end of the cooperative's fiscal year the board of directors appraises the financial condition of the cooperative and decides the amount of profits or net income that shall be returned to members on the basis of use of the cooperative as a patronage refund, how much should be used to retire older member equity (redemption of equity), and how much should go into "un-allocated equity". The directors decide, based on the equity capital needs of the cooperative, what portion of the patronage refund should be paid out in cash to the members and what portion should be retained ("retained patronage refund") to build up member's equity obligation to provide necessary operating capital. This retained patronage refund is referred to as "allocated equity". The retained patronage refund is the equity investment by an individual member. This equity capital is distinguished from "un-allocated equity" or "permanent capital". Un-allocated equity is not associated with any one member, but is equity capital as a whole. There is no obligation for the cooperative to pay back the un-allocated equity capital to members unless the cooperative would dissolve. It makes sound business sense to have some un-allocated equity capital to serve as a capital reserve. Members of a cooperative share in both the profits and losses of a cooperative. In the event that occurs, the loss can be covered by drawing down the un-allocated reserve. Most lenders require the cooperative to maintain a level of un-allocated equity.

But, in the case of retained patronage refunds, this is allocated equity and there is an obligation to pay back - redeem - this equity in a reasonable period of time. Therefore, allocated equity is temporary equity capital and not permanent capital. This is a unique means of financing cooperatives and is referred to as a "revolving fund". Current active members of the cooperative invest a portion of their net income from the cooperative each year as their equity capital responsibility (retained patronage refund), and a portion of the cooperatives net income is used to redeem older equity (retained patronage refunds allocated 5, 7, 10 years ago). Thus, this revolvement fund plan maintains the ownership of the cooperative in the hands of active members and is consistent with the definition of a true cooperative - ownership by users.

The Commission directive to reclassify patronage capital to classify retained earnings as "Additional Pain-in Capital" would, by all indications, choke-off the primary source of capital available to the Board for use in the members' best interests. The revolving fund of retained, allocated patronage refunds contains members' money. Revolvement of paid-in capital does not fit the operational scheme established for cooperatives in tax law. Indeed, if tax status is affected because of failure to operate on a cooperative basis, it could have dire tax consequences for the cooperative and its members and ratepayers.

Finally, there may be tax implications on how equity capital is handled. The IRS has established a "single tax" treatment on net income generated from use of patronage of the cooperative. That is, in the year net income is earned, either the cooperative or the member will assume the tax obligation. Net income from patronage may be allocated to members according to patronage, and by doing so, the cooperative pays no income tax on this net income. The member assumes the tax obligation. But, this is only possible if the member consents, that is, agrees to this. Consent is usually provided in the bylaws of the cooperative (which were approved by members) or in a signed membership agreement. A telephone cooperative may retain up to 100% as allocated equity (retained patronage refund). The member assumes the tax obligation on the entire 100% of the patronage allocated, in the year in which it is allocated. Later, when the retained patronage refund is redeemed, there is no tax obligation for the member because taxes were previously paid. There is an exception: the member has income tax liability if his/her business with the cooperative was itself for a business purpose. The tax is owed by the patron because all or part of the member's telephone bill was (presumably) deducted as a business expense.

So clearly, from an accounting standpoint, in order to meet the recognized business structure as a cooperative, to fulfill the accepted operating principles of a cooperative and to meet the IRS tax rulings, allocated retained patronage refunds must be distinguished from un-allocated equity (direct member investment, preferred stock, etc.). Clearly, these allocated retained patronage refunds are not "additional paid-in capital" by members of the cooperative.

Sincerely,

Robert Cropp, Professor and Director,
Univ. Wisconsin Center for Cooperatives

05-US-115

RTFC

RURAL TELEPHONE FINANCE COOPERATIVE
2201 Cooperative Way · Herndon, Virginia 20171-3025
703-709-6700

Ms. Lynda Dorr, Secretary
Public Service Commission of Wisconsin
P.O. Box 7854
Madison, Wisconsin 53707-7854

Subject: Wisconsin PSC Docket 05-US-115 - Accounting Treatment of Patronage Capital of Telecommunications Cooperatives

Dear Ms. Dorr and Commissioners:

It has come to the attention of the Rural Telephone Finance Cooperative (RTFC) that your Commission is investigating possible changes in the accounting treatment for the patronage capital of telecommunications cooperatives. As the primary private lender to the rural telecommunications cooperatives in Wisconsin, RTFC has a significant interest in the outcome of this proceeding and submits the following comments in the docket indicated above.

The Rural Telephone Finance Cooperative is a not-for-profit, member-owned financing cooperative that provides loans and other financial services to RUS-eligible telephone companies and cooperatives and their affiliated organizations. RTFC is affiliated with the National Rural Utilities Cooperative Finance Corporation (CFC), the primary private lender to America's rural electric cooperatives. CFC (including RTFC) has assets of approximately $20 billion.

RTFC presently has approximately $29 million lent to Wisconsin's telecommunications cooperatives. These funds were used to help build Wisconsin's rural telecommunications infrastructure. With this much exposure in Wisconsin, we have a direct interest in the finances and regulatory treatment of our borrowers.

<u>Issue 1:</u> "Whether the Commission's patronage capital accounting directives as it concerns accounts 4520, 'Additional Paid-In Capital' and 4550, 'Retained Earnings' and its interaction with Wis. Stat.196.204 addressed in the Chibardun Order should be extended to all ILEC telecommunications cooperatives or a portion thereof. If not, whether the Commission's Chibardun order concerning patronage capital accounting should be rescinded."

<u>RTFC Comment:</u> Cooperatives, whether agricultural, electric, telephone or financing, must allocate margins to members in order to legally function as cooperatives. RTFC is a

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South Dakota cooperative. Article X of our bylaws sets out the requirements for the allocation and distribution of the "net proceeds" (margins) of the cooperative. Included in this article is the sentence, "All such amounts credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Association corresponding amounts for capital." This constitutes "subordination of capital", which along with "democratic control" are principles necessary to meet the IRS test for acting on a cooperative basis.

The Commission's action in the Chibardun Order puts Chibardun's cooperative status at risk. This could mean that the cooperative incurs income tax on member-derived revenues – a significant additional expense. Also, if the margins allocated to patrons are perforce locked up in "Additional Paid-In Capital," the member/patrons of the cooperative are deprived of their share. If one considers the patrons' allocated margins as an offset against the cost of service, the Commission has effectively raised the local service rates of Chibardun ratepayers. This action should not be applied to the other telecommunications cooperatives in Wisconsin, nor should it any longer be applied to Chibardun.

Not only is this a rate increase, but a taking of the members' equity in the cooperative. By putting member's equity in "Additional Paid-In Capital," it is locked up and not available to distribute to member/patrons on whatever schedule Chibardun had previously followed. The only other likely option for returning patronage to member/patrons is for Chibardun, on a going forward basis, to distribute all or nearly all margins to the patrons. This will cripple Chibardun's ability to raise debt capital not only for unregulated, competitive ventures, but also for core ILEC improvements and extensions. The Commission decision in the Chibardun case punishes Wisconsin residents and an organization owned by and operated for the benefit of rural Wisconsin residents. It should rescind the decision immediately.

<u>Issue 5:</u> "Whether the treatment or consideration accorded to patronage capital by other governmental agencies (e.g., RUS), via legal requirements (including court cases or other legal directives) or external lenders influence in any way and, if so, to what extent, the accounting treatment to be accorded to patronage capital."

<u>RTFC Comment:</u> All of the telecommunications cooperatives in Wisconsin get the bulk of their debt financing for core LEC infrastructure from the RUS and Rural Telephone Bank (RTB). RTFC is primarily a supplemental lender, providing senior debt capital for projects for which RUS/RTB funds are not available. We hope that the RUS will clarify the impact the Commission's position on the accounting treatment for patronage capital will have on RUS' ability to provide further funding to Wisconsin cooperatives and on the cooperatives' ability to comply with existing mortgage covenants.

RTFC, as a national lender, provides funding for telephone cooperatives in all states that have such entities. Because the regulatory environment in a state materially influences our financing decisions, we make every effort to stay abreast of adverse actions. We are aware of no other state besides Wisconsin in which regulators have issued or proposed rules that treat patronage capital as anything other than retained earnings.

Relative to our financing of Wisconsin telephone cooperatives, RTFC sees the following impacts unless the Commission reverses its position on patronage capital:

- The ability of these cooperatives to secure financing for non-core projects will be non-existent. Given the Wisconsin law that limits a telco's ability to invest in subsidiaries engaging in competitive ventures to the amount of its retained earnings, the Commission's reclassification of patronage capital to "Additional Paid-In Capital" reduces telecommunications cooperatives' retained earnings to zero. Thus these cooperatives will have no funds that they can legally invest in new, competitive ventures.
- Without equity investment by the cooperative, neither RTFC nor any private lender will lend to finance the competitive entity. RTFC has never provided 100 percent debt financing. Certainly in today's challenging capital markets environment, no lender would provide 100 percent debt financing for a start-up, competitive enterprise.
- Absent financing for these telecommunications cooperatives, residents of rural Wisconsin will be deprived of telecommunications services such as high-speed data and video that their urban counterparts enjoy. Large, absentee-owned service providers will be able to reap monopoly profits without fear of competition and without the need to invest in modernized facilities.

In summary, RTFC supports the proposal of the telecommunications cooperatives in this matter. Retained equity is essential for these cooperatives to borrow funds needed to improve and extend telecommunications services. The cooperatives' proposal to create two sub-accounts of account 4550 will preserve patrons' allocations and assure the cooperative that it will have the necessary member capital for growth and reinvestment.

RTFC strongly urges the Commission to adopt the two sub-categories of retained earnings for telecommunications cooperatives in order to accommodate the unique capitalization regime under which cooperative utilities operate. To do otherwise will risk severe financial injury to the cooperatives and their patrons.

Please feel free to contact me if you have any questions. Thank you for your consideration.

Henry I. Buchanan, III
Vice President of Industry Affairs

05-US-115

USDA

United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

September 27, 2002

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TELECOMMUNICATIONS DIVISON

Ms. Lynda L. Dorr
Secretary of the Commission
Public Service Commission of Wisconsin
610 N. Whitney Way
Madison, Wisconsin 53705

RE: Docket 05-US-115

Dear Ms. Dorr:

The Rural Utilities Service (RUS) appreciates the opportunity to respond to the Commission's request for comments regarding the accounting treatment for patronage capital by telecommunications cooperatives as addressed in the above referenced docket.

RUS is an agency of the United States Department of Agriculture, empowered by the Rural Electrification Act of 1936 (RE Act), as amended, to provide financing to Rural America for the purpose of furnishing and improving electric, telecommunications, and water and environmental services. RUS provides financing for the construction of plant to approximately 700 telecommunications companies and cooperatives. RUS borrowers keep Rural America connected to one another and the world.

A rural telephone cooperative is a not-for-profit business organization owned entirely by its members and operated for the benefit of those members. A cooperative's operations are governed by its bylaws, which serve as a contractual agreement between the cooperative and its members. At the end of each fiscal year, any operating profit (margin) earned by the cooperative is allocated to the members in the form of patronage capital (capital credits). While the tax code requires that a cooperative return these capital credit allocations, in cash, to the members within a reasonable period of time after the close of the fiscal year, utility cooperatives have been granted an exemption. Utility cooperatives are permitted to retain allocated capital credits until such time as the cooperative's management determines that these payments would not impair

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the cash position of the cooperative. This exemption is, in part, justified by the extremely large investment in plant assets required for the operation of a utility.

The accounting for patronage capital is not prescribed in generally accepted accounting principles; rather, it was developed by RUS and its borrowers and is, in effect, a hybrid of the accounting that would be found in the equity section of a profit oriented entity. The equity section of a profit-oriented entity consists primarily of capital stock and retained earnings. Capital stock represents the capital contributed to the entity by its owners (investors) while retained earnings, which is the accumulated earnings net of dividend distributions, represents the return, to the owners, on capital that they have invested. Patronage capital, which is the major component of the equity section of a cooperative, is a combination of capital stock and retained earnings. Patronage capital represents both the accumulation of earnings net of patronage refunds (similar to retained earnings) and the owner's (member's) contribution of capital to the cooperative (similar to capital stock).

RUS has always taken the position that assigned patronage capital represents capital contributed to the cooperative by its members. RUS recommends that the bylaws of an RUS cooperative clearly state that the amounts paid in excess of costs and expenses of providing service are furnished as capital. RUS' position that assigned patronage capital represents capital contributed to the cooperative by its members would appear to be supported by the United States Tax Court which ruled that the payment of patronage dividends represents a return of capital.

As a condition of the mortgage, RUS requires compliance with 7 CFR Part 1770, Accounting Requirements for RUS Telecommunications Borrowers (Part 1770), a uniform system of accounts (USoA) that permits its borrowers to maintain only one set of books for financial and regulatory record keeping. This system of accounts is based on the Federal Communications Commission's Part 32 modified to accommodate accounting for RUS debt and the cooperative form of organization. Within Account 4550, Retained Earnings, RUS has added the subaccounts, 4550.1-4550.6. Specifically Accounts 4550.4, Patronage Capital Assignable, and 4550.5, Patron's Capital Credits Assigned, require the segregation of equity contributed by the members/owners of a telephone cooperative in the form of unretired patronage capital from traditionally recognized retained earnings that would be found on the balance sheet of a for-profit business entity. Because this segregation exists, we believe it is unnecessary to reclassify patronage capital assigned or assignable to Account 4520, Additional Paid-In Capital. The balances in these accounts are readily available for the purpose of reporting to the Wisconsin Public Service Commission (Commission). For this reason we see no reason to add Accounts

4550.1, Retained Earnings, Patronage Capital Unassigned, and 4550.2, Retained Earning, Patronage Capital Assigned, as they already exist in Part 1770. Specifically, Accounts 4550.1 and 4550.2 have already been designated as Operating Margins and Nonoperating Margins, respectively, in Part 1770. Additionally, Part 1770 contains Account 4540.21, Memberships Issued, to identify the value of membership certificates issued. We see no reason to create a new Account 4511, Members Equity, for this purpose. We have included as an attachment to these comments, descriptions of Account 4520, Additional Paid-In Capital, Account 4540.21, Memberships issued, as well as Account 4550, Retained Earnings, and all related subaccounts.

In conclusion, RUS believes that Part 1770, as it currently exits, accommodates the circumstances discussed in Docket 05-US-115 pertaining to the accounting for cooperatives.

Sincerely,

Kenneth M. Ackerman

KENNETH M. ACKERMAN
Assistant Administrator
Program Accounting and Regulatory Analysis

Attachment

Selected Definitions from 7 CFR Part 1770

4520 – Additional Paid-In Capital

(a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.

(b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

4540.21 - Memberships Issued.

This account shall include the face amount of membership certificates outstanding. A subsidiary membership certificate record shall be maintained to reflect the detail of the balance in this account.

4550 – Retained Earnings

(a) This account shall include the undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includable in the other accounts appropriate for inclusion of stockholders' equity.

(b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this Commission.

4550.1 - Operating Margins

This account shall include amounts received or receivable from the furnishing of telecommunications service in excess of costs incurred in the furnishing of such service. If costs exceed revenues, the excess cost of furnishing telecommunications service shall be recorded as a debit to this account.

4550.2 - Nonoperating Margins

This account shall include margins arising from transactions or activities not related to the furnishing of telecommunications service. Included in this account are receipts from investments, income from investments, income from nonoperating plant, and revenues derived from services performed for others incident to the company's regulated telecommunications operations.

4550.3 - Other Margins

This account shall include patronage capital credits assigned to the cooperative by other nonprofit organizations prior to January 1, 1970, which were not credited directly to an operating expense account as a reduction in the cost of furnishing telecommunications service. No entries shall be made to this account unless it is to distribute or eliminate prior balances in conformance with the bylaws of the cooperative.

4550.4 - Patronage Capital Assignable

This account shall include all amounts transferred from operating margins, nonoperating margins, and other margin accounts, which are assignable to individual patrons.

4550.5 - Patrons' Capital Credits Assigned

This account shall include the amounts of patronage capital which have been credited to individual patrons. A subsidiary patronage capital ledger shall be maintained so as to reflect the amount of capital furnished by each patron and the amount of such capital returned to the patron.

4550.6 - Gain on the Retirement of Capital Credits

This account shall include credits resulting from the retirement of patronage capital through settlement of individual patrons' accounts at less than 100 percent of the capital assigned to the patron. The portion of patronage capital not returned to patrons under such settlements shall be debited to Account 4550.5, Patrons' Capital Credits Assigned, and credited to this account.

This account shall also include amounts representing patronage capital authorized to be retired to patrons who cannot be located. Returned checks issued for retirements of patronage capital, after an appropriate waiting period, shall be credited to this account and a record shall be maintained adequate to enable the cooperative to make payment to the patron if and when a claim has been established by the patron.

Hillman, Karl PSC

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Rural Utilities Service

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To:	Lynda L. Dorr	**From:**	Kenneth M. Ackerman
Fax:	608-266-3957	**Pages:**	5 not including cover
Phone:	608-266-1266	**Date:**	09/27/02
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• **Comments:**

05-US-115

WSTA SMALL COMPANY COMMITTEE

Members of Wisconsin State Telecommunications Association, Inc.

6602 Normandy Lane, Madison, WI 53719
Phone: 608/833-8866 Fax: 608/833-2676 E-mail: info@wsta.info URL: www.wsta.info

September 30, 2002

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WISCONSIN PUBLIC SERVICE COMMISSION

Lynda L. Dorr
Secretary of the Commission
Public Service Commission of Wisconsin
P.O. Box 7854
Madison, WI 53707-7854

RE: Docket No. 05-US-115 – Accounting Treatment for Patronage Capital by Telecommunications Cooperatives

Dear Ms. Dorr:

I write to you today, on behalf of the Wisconsin State Telecommunications Association (WSTA) – Small Company Committee, in support of Wisconsin's 11 telephone cooperatives and their comments regarding Docket No. 05-US-115 – Accounting Treatment for Patronage Capital by Telecommunications Cooperatives.

We believe a PSC order directing telephone cooperatives to classify retained earnings in account 4520 as additional paid-in capital would result in unnecessary hardship on the co-ops and would negatively affect their patrons. If ordered, this re-classification of retained earnings could jeopardize the cooperative status of the ILEC co-ops, and eliminate the primary source of equity available to cooperatives.

We also agree that re-classification of retained earnings, as additional paid-in capital, would put the co-ops' tax status at risk because the return of patron's retained capital is fundamental to cooperative "operation on a cooperative basis." In addition, there is no known precedent for the re-classification, so the IRS position is unknown. A negative decision by the IRS could have significant, negative and unwarranted consequences for cooperatives.

As you probably already know, Wisconsin has more independent small telephone companies and cooperatives than almost every state in the union. For decades rural Wisconsin has benefited because these small telephone companies and cooperatives have provided a high quality and level of service to their customers. These companies and cooperatives are often the only providers of unregulated and competitive services to rural areas including, Internet service, local telephone service, sophisticated telecommunications equipment and maintenance, and cable television service.

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Therefore, the WSTA – Small Company Committee urges the PSCW to make a ruling supporting the proposal of the cooperatives to restore two sub-accounts of the Uniform System of Accounts to accommodate cooperative patronage capital. Thank you in advance for your thoughtful consideration of this matter.

Sincerely,

Mike Jensen (CWK)

Mike Jensen, Chair
WSTA Small Company Committee

05-US-115

WARREN J. DAY
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September 30, 2002

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TELECOMMUNICATIONS DIVISION

Ms. Lynda Dorr, Secretary
Public Service Commission
P.O. Box 7854
Madison, WI 53707-7854

Re: TRANSMITTAL LETTER AND MOTION: 05-US-115 - Accounting Treatment for Patronage Capital by Telecommunications Cooperatives

Dear Ms. Dorr:

The Wisconsin State Telephone Cooperative Association and the Wisconsin Federation of Cooperatives jointly submit the enclosed comments and exhibits in the above-referenced investigation. We have included the original and fifteen copies.

MOTION

The Wisconsin State Telephone Association and the Wisconsin Federation of Cooperatives (movants) hereby request an order by the Commission to create two subaccounts of retained earnings in the PSC USOA to accommodate the recording of patronage capital of ILEC cooperatives. The movants also request creation of a new account for the recording of cooperative "member equity". The particulars supporting this motion, including precise wording of the accounts, in contained in the attached comments in Docket 05-US-115.

Thank you for your cooperation.

Sincerely yours,

W. J. Day

Warren J. Day
Attorney, Wisconsin Telephone Cooperatives and
the Wisconsin Federation of Cooperatives

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Wisconsin State Telephone Cooperative Association

Wisconsin Federation of Cooperatives

Comments in

Public Service Commission Docket

05-US-115

October 1, 2002

Attorney Warren J. Day
608-258-4382

Wisconsin State Telephone Cooperatives Association
Wisconsin Federation of Cooperatives

Comments in Docket 05-US-115
October 1, 2002

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DOCKET 05-US-115

WISCONSIN STATE TELEPHONE COOPERATIVE ASSOCIATION
WISCONSIN FEDERATION OF COOPERATIVES

OCTOBER 1, 2002

SUMMARY OF COMMENTS

- Proposed PSC Reclassification Of Cooperative Patronage As Additional Paid-In Capital Is Inconsistent With Decades Of Cooperative Accounting Conventions and Legal Precedent

- The Subaccounts Requested by ILEC Cooperatives Actually Restores The PSC Pre-1988 Treatment Of Cooperatives' Patronage Capital - Two Subaccounts of Retained Earnings

- The Accounting Change Would Threaten Cooperatives' Tax Status And Interfere With "Operation On A Cooperative Basis" - A Legal Principal Fundamental To The Cooperatives

- The Commission Has Mis-Interpreted The Meaning And Operation Of The Standard Cooperative Bylaw In Use For Decades And Supported By Law

- Rural Wisconsin and Cooperative Members will Be The Big Losers Under PSC Reclassification Because It Will Limit Retained Earnings Available For Investment In Rural Wisconsin, And Risk Investments Made To Date In Rural Areas.

- Reclassification By The PSC Would Ignore The Desires Of Cooperative Members, Expressed In Annual Cooperative Meetings And Through Democratically Elected Directors

1. Whether the Commission's patronage capital accounting directive as it concerns accounts 4520, Additional Paid-in Capital and 4550, Retained Earnings, and its interaction with Wis. Stat. s.196.204 addressed in the Chibardun Order should be extended to all ILEC cooperatives, or a portion thereof. If not, whether the Commission's Chibardun Order concerning patronage capital accounting should be rescinded.

Introduction to all comments by telecommunications cooperatives

The cooperatives believe a PSC order directing them to classify retained earnings in account 4520 as additional paid-in capital (**hereinafter "re-classification"**) was misguided and based on a fundamental lack of misunderstanding of how cooperatives operate financially. The reclassification order could jeopardize the cooperative status of the ILEC co-ops, and eliminate the primary source of equity available to cooperatives.

So important is this issue to (all) co-ops that we invited comments from Professor Robert Cropp, a University of Wisconsin expert on cooperatives, from the National Rural Utilities Cooperative Finance Corporation (a prominent co-op lender), and from the Rural Utilities Service of the USDA, a lending agency and rural development advocate. Also consulted in the preparation of these responses was Mr. Thomas Strait, an expert in tax and accounting for telephone and electric cooperatives. (Resume' attached.)

Re-classification of retained earnings (Account 4550), as additional paid-in capital (Account 4520) puts the co-ops' tax status at risk because the return of patron's retained capital is fundamental to co-operative "operation on a cooperative basis." (Rev. Rul. 72-36, Attachment 5 to June 4, 2002 letter.) There is no known precedent for the reclassification, so the IRS position is unknown. A negative decision by the IRS would have monumental consequences for the cooperatives.

A Short Answer to Issue 1, First Part

No, the Commission "re-classification" order in Chibardun should not be extended to other ILEC cooperatives. The bylaw common to all of the ILEC co-ops has a meaning that is well-established in law and used uniformly by cooperatives (utilities and non-utilities alike) across the nation.

The FCC USOA defines account 4520 as follows:

> (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.

(b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to this account to the extent that there exist credits in this account for the same class of stock: otherwise to Account 4550.

As you can see the intent of FCC USOA 32.4520 is for stock based Companies.

(Mr. Thomas Strait has provided a comprehensive response which addresses several of the issues in the docket. The complete answer is included here and there will be cross-reference by paragraph number in other responses.)

Mr. Strait writes:

(1) In general, the concept of "additional paid in capital" in financial accounting applies to entities organized with "capital stock." The spread between the issue price and par or stated value of issued stock is typically reported on the balance sheet under a heading such as "Additional Paid-In Capital" or "Capital in Excess of Par Value." It is most commonly used by for-profit corporations to account for the total sales price of stock sold to investors-owners, although a limited number of farmer cooperatives may be organized on a stock basis.

(2) Borrowers of from the Rural Utilities Service (RUS) must comply with the Uniform System of Accounts (USOA) it publishes, and any system of accounts prescribed by federal or state regulators. Pursuant to the RUS USOA for telephone borrowers (as published on line at www.usda.gov/rus/telecom/publications/html/1770.htm), the following is stated as it relates to using accounts 4510 and 4520:
:

(3) Account 4540.11 Capital Stock Subscribed.

> This account shall include the **par value** of capital stock for which legally enforceable subscriptions have been received but for which, at the date of the balance sheet, stock certificates have not been issued.
> **This account shall be debited and Account 4510, Capital Stock, credited when a subscriber has paid the subscription in full and stock certificates are issued**. [Emphasis added.]

(4) The companion account to Account 4540.11 is described in the USOA as follows:

Account 4540.31 Installments Paid on Capital Stock.

> This account shall include the amount of

installments paid on capital stock on a partial or installment payment plan by subscribers against whom there is no legally enforceable subscription contract, and who are entitled to be reimbursed the principal amount of their payments, with or without interest, in the event they fail to complete payment for the stock and receive certificates therefore.

This account shall be debited and Account 4510, Capital Stock, credited with the par value of capital stock when the total subscription is received and the stock certificates are issued. **Any difference between the purchase price of the subscription and the par value of the stock shall be credited to Account 4520, Additional Paid-In Capital.** [Emphasis added.]

(5) One might question why the RUS would have Accounts 4510 and 4520. The answer is that a substantial number of RUS telephone borrowers are small, for-profit telephone companies organized on a stock basis. These accounts **do not apply** to telephone cooperatives organized on a membership basis.

(6) Cooperatives typically are organized under "not-for-profit" statutes of the various states. Telephone cooperatives are organized as membership organizations and may or may not actually collect a membership fee when a customer becomes a member. In recent years there has been a trend among telephone cooperatives not to collect any membership fee from new members.

(7) Therefore, it appears that the Commission is trying to force, via erroneous accounting prescriptions, capital structures for telephone cooperatives that are inappropriate and incorrect. The notion of "Capital Stock" and "Additional Paid-In Capital" apply only to stock companies.

(8) As for the standard language appearing in virtually all telephone cooperatives' bylaws regarding the excess collected over cost, it is derived in part from federal income tax law requirements, and from cooperative principles that have existed for over 100 years.

(9) In terms of the historical context, cooperatives have served groups of individuals who have come together to obtain a service **at cost**. Because cooperatives are non-profit generally, there is no one else to provide equity capital to such an organization. Accordingly, the members have had to furnish equity themselves, albeit temporarily, via retained patronage allocations. As newer members have joined, the older have members received their vintage patronage credits in cash redemption.

(10) Likewise, the same policies have applied to both tax exempt and taxable telephone cooperatives. Beginning in 1924, most telephone cooperatives were afforded tax exemption under Internal Revenue Code (the Code) Section 501(c)(12) or its predecessors. In 1992, the Internal Revenue Service (IRS) issued a pronouncement that caused large numbers of telephone cooperatives across the country to fail the so-called 85 percent member income test prescribed for tax exemption. The change related to the mechanical computation of a member income and access revenues for purpose of that statutory requirement.

(11) However, failure to satisfy exemption requirements of the Code in no way altered these organizations' cooperative status. It merely made the affected organizations "taxable" cooperatives. They remain "cost" organizations even today.

(12) Taxation of most cooperatives in the United States is governed by sections 1381 through 1388 of the Code. However, in 1962 when those provisions were enacted, rural telephone and electric cooperatives were specifically excluded. Instead, these utility cooperatives continued to be taxed under prior cooperative tax law that was not codified.

(13) That earlier tax law was based on an amalgamation of federal court decisions and IRS pronouncements issued during the period of 1915 through 1962. The earlier cooperative tax law was considerably more favorable regarding patronage allocations and other tax return reporting issues. Specifically, telephone cooperatives subject to the earlier law do not have to pay any cash on a patronage dividend (capital credit) at the time of allocation, but nevertheless are allowed to excluded all "qualifying" patronage allocations from taxable income.

(14) Under so-called "Pre-1962" tax law several key federal court decisions are viewed as central to the taxation of cooperatives. In *Farmers Cooperative v. Birmingham*, 86 F. Supp. 201 (1949), a federal district court provided an exhaustive description of the foundations of cooperative operation and how the "excess" collected "over cost" allocated to members represented a deferred price adjustment, not profit. See also, *Pomeroy Cooperative Grain Company* 31 T.C. 674, acq. 1959-2 C.B. 6 (1958).

(15) Perhaps the most concise definition of the term "cooperative" for federal tax purposes was provided by the U.S. Tax Court in *Puget Sound Plywood, Inc. v. Commissioner,* 44 T.C. 305 (1965), acq. 1966-1 C.B. 3. In an opinion that has been cited repeatedly by other courts and the IRS, the Tax Court said that the three guiding principles at the core of economic cooperative theory as:

1. **Subordination of capital** (cooperatives pay little or no return on members' equity capital);

2. **Democratic control** by the members (typically on a one member, one vote basis); and

3. **Allocation of margins based on participation.**

(16) Further, the Tax Court affirmed that cooperatives are "cost organizations."

(17) Therefore, a telephone cooperative's patronage capital balance cannot earn a return on investment. That is not to say, however, that taxable telephone cooperatives cannot engage in limited activities that would produce ordinary profit. All profit activities would be deemed to be "nonpatronage" income and would be fully taxable at rates applicable to U.S. corporations under the Code. Those net amounts can be retained by a telephone cooperative as reserves or retained earning, or can be allocated to the members based on patronage.

(18) However, for patronage dividend (capital credit) allocations to be "excludible" from income for tax purposes, the Tax Court in *Pomeroy Cooperative Grain Company, supra,* set forth three key tests. Those are:

1. The allocations must be made pursuant to a pre-existing legal obligation;

2. The allocations must be made on the basis of the member's participation in the cooperative; and

3. The margins allocated must be derived from transactions conducted with or for the particular member (i.e., be patronage derived).

(19) To cope with sometimes-Byzantine cooperative tax law requirements, standard bylaw language evolved over the years that various federal courts accepted as sufficient. Because of this, language recommended by the National Telephone Cooperative Association based on those requirements similar to the following should appear in all taxable telephone cooperatives' bylaws to ensure their capital credit allocations can be excluded as "qualified" patronage dividends for federal income tax purposes:

<u>Patronage Capital In Connection With Furnishing Telecommunications and Information Services</u>.

(1) In the furnishing of telecommunications and information services, the Cooperative's operations shall be so conducted that all patrons will, through their patronage, furnish capital for the Cooperative. In order to induce patronage and to insure that the Cooperative will be operated on a non-profit basis, **the Cooperative is obligated** to account **on a patronage basis** to all its patrons for all amounts received and receivable from the furnishing of telecommunications and information services in excess of operating costs and expenses properly chargeable against the furnishing of such services. All such amounts in excess of operating costs and expenses for telecommunications and information services at the **moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital.** [Emphasis added.]

> (2) The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses derived from telecommunications and information services. The books and records of the Cooperative shall be set up and kept in such manner that at the end of each fiscal year the amount of capital, if any, so furnished by the patron for telecommunications and information services is clearly reflected and credited in an appropriate record to the capital account of each patron, and the Cooperative shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to the patron's account. All such amounts credited to the capital account of any patron shall have the same status as though it had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital.

(20) At the same time, however, the cooperative is not authorized to retain this patronage capital forever. To ensure that retained patronage is not a permanent investment, a telephone cooperative's bylaws should contain language similar to the following:

> If, at any time prior to dissolution or liquidation, the Board shall determine that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part. All allocations and retirements of capital shall be at the discretion and direction of the Board as to kind, timing, method, and type of assignment and distribution.

(21) This provision places the responsibility for redemption of the patronage capital retained by the cooperative in the hands of the board of directors that is democratically elected by the participating customer-members. Needless to say, if a board of directors unreasonably refuses to redeem patronage capital on a timely basis, the member-customers may replace them with new directors.

(22) The rotation or redemption cycle for member patronage capital can vary depending on the financial condition of the cooperative. Average capital rotation periods for telephone cooperatives range from eight to fifteen years.

(23) If a board of directors or a public service commission took action to remove patronage capital from the proper accounting category and place it into what in virtually every case is a more permanent equity account (i.e., Additional Paid-In Capital) it could give rise to serious federal income tax issues. Beyond the fact that it would be inappropriate accounting for a membership organization, it could raise serious questions under the tax law as to the nature of the margin collected. As opposed to the deferred price adjustment theory under which cooperatives have traditionally operated, the margin might appear to be more akin to income by virtue of the contribution to permanent equity capital.

(24) Initially, the IRS might not be opposed to the treatment. However, over time as the

Additional Paid-In Capital balance grew, it could cause questions as to why that account was being incorrectly used and whether or not a "pre-existing" legal obligation was present in the traditional sense.

(25) If the "pre-existing" legal obligation is jeopardized or destroyed by subsequent action of either the cooperative itself or a regulator, then the original exclusion from taxable income would be placed at risk. In the worst case, the IRS could claim that the prior capital credit exclusions claimed by the cooperative should be denied and income taxes could be assessed at corporate tax rates under the Code.

(26) In conclusion, the telephone cooperatives in question are not stock corporations, but rather are non-profit membership organizations. Use of the various Capital Stock and Additional Paid-In Capital accounts appear in the RUS Uniform System of Accounts are applicable to stock companies, not membership organizations. Any reclassification of existing patronage capital accounts to such stock company accounts would not only be incorrect, but could call into question whether the "pre-existing" legal obligation required for exclusion of capital credits from taxable income really exists. That type of risk should be unacceptable to the Commission.

Order As It Should Apply to Chibardun and Nelson

Although the Commission has indicated its reluctance to change its position in Chibardun on accounting treatment of patronage capital, we are unable to make a rational distinction between that decision and its extension to all other ILEC cooperatives.

The cooperatives believe the interpretation of the Chibardun bylaw was incorrect with respect to treatment of patronage capital. The decision was based on a reading of a bylaw that is substantially identical to the bylaws of the other co-ops. As we demonstrate in this filing, re-classification of patronage capital from retained earnings to additional paid-in capital is a mistake that should not be compounded.

Issue 2. *Whether the language in the respective ILEC cooperatives' bylaws influence in any way and, if so, to what extent, the accounting treatment to be accorded patronage capital.*

The bylaw at issue is **fundamental** to accounting treatment suggested by the cooperatives. The bylaw in question is: *"All such amounts* [i.e., revenues in excess of cost] *credited to the capital account of any patron shall have the same status as though paid to the patron in pursuance of a legal obligation to do so, and the patron has then furnished the Cooperative corresponding amounts for capital".*

This bylaw language is essentially the same for all cooperatives. It is deceptively simple, yet it is the legal framework by which co-ops raise capital, operate on an at-cost basis, and return revenues in excess of costs to the members who own the cooperative. (Also see Strait response, para 8-19.)

The meaning and application of this bylaw is fundamental to co-op operation and tax status. Its meaning is complex, rooted in the Internal Revenue Code. 34 Am Jur 20175 explains the key phrases and concepts.

a) The purpose of the bylaw is to enable exclusion [1] of patronage refunds paid-out to patrons from the co-op's net income. The refunds are essentially a price adjustment not a dividend on invested capital.
b) "[T]he same status as though paid" recognizes that the co-op can "pay" the patronage to the member by giving written notice that the margins have accrued in the member's name (if the bylaw is in place), or by payment of money, a certificate of indebtedness, or other property.
c) The Internal Revenue Code has recognized in sec. 1388(c); Reg. s.1.1388(c) that the members consent to this method of written notice by virtue of joining a cooperative under its membership agreement.[2]
d) The "legal obligation" of the cooperative to pay patronage refunds is established in the co-op's articles or bylaws, and is statutorily required in Wisconsin law. 185.45, Wis. Stats.

Account 4550 has been adopted by the FCC and the RUS to track and report these margins in excess of cost (net income) which are retained by the cooperative, allocated, and eventually revolved back to members. From 4550, the elected Board of Directors is empowered to invest in other activities, pending eventual payout to members. The account may contain margins from both utility and non-utility sources. Among the non-utility sources would be interest income, rent and other income not attributable (and

[1] Cooperatives' joint submittal dated July 31, 2002 mistakenly called this a deduction from income.
[2] Section 1381 (often referred to as Subchapter T) specifically does not apply to telephone and electric cooperatives, meaning the prior, pre-1962 laws, which were not codified, still applies to them. The essential difference is that telephone and electric cooperatives must meet an income-source test in order to qualify for tax-exempt status. That issue is not relevant here. In most other respects, tax regulation is the same or very similar.

permissibly not allocated) to members. Neither source of income should be reclassified as 4520 funds of the utility.

How would use of account 4520 influence the accounting treatment of patronage capital?

First, the accounting treatment ordered by the commission does not fit the cooperative business model. (Strait, para. 8)

Second, re-classification of retained patronage as additional paid-in capital causes members to further capitalize the utility on a permanent basis and risks the right of patrons to these patronage refunds. As a result, cooperatives would be in jeopardy of losing their tax status as a result of reclassification. Shifting members' future patronage refunds to a permanent equity account risks an IRS finding that "operation on a cooperative basis" is not occurring. The tax consequences could be staggering. (Strait, para 23-25.)

As discussed in response to issue 6, the loss of cooperative status has grave consequences - greater, even, than loss of the patronage exclusion from income.

Third, 4520 funds are reserved for the utility operations, not diversified non-utility activities of the cooperative. The cooperative utility recovers all its normal operating expenses and expansion capital through rates. Additional capital from outside the rate base is not needed. The reclassification would eliminate the primary source of member equity for non-utility purposes. This is addressed further in answer to issue 3.

Fourth, the RUS imposes guidelines on utilities that borrow federal funds in order to assure repayment of federal loans. To the extent that the PSC reclassification would alter the financial structure of the cooperatives for purposes of RUS or other lender accounting, and jeopardizes the good standing of the cooperative with the lenders. In particular, the RUS annually sets an "Allowable Distribution" which limits patronage refunds in order to maintain a proper financial structure. The cooperatives cannot predict the effect of reclassification on the RUS allowable distribution.

Fifth, the accounting reclassification violates guidelines for borrowers established by RUS. This is discussed more in answer to issue 5

Sixth, the reclassification of funds to 4520 would distort Wisconsin's statutory measure of retained earnings under the limitation of s.196.204(1) ("Except for retained earnings, a telecommunications utility may not subsidize....") and effectively <u>eliminates</u> the pool of retains which cooperatives are entitled to use in non-utility activities. The Commission cannot reasonably conclude that this was the intention of the Legislature when enacting section .204. (See more discussion in response to issue 3.)

<u>The Additional Bylaw Language of Nelson and Chibardun</u>

The notice in this docket prominently referenced an additional bylaw enacted by Nelson Telephone Cooperative and Chibardun Telephone Cooperative. That bylaw has no relevance to the narrow issue before the commission: whether retained (patronage capital) earnings should be re-classified as additional paid-in capital.

However, we offer this short explanation. The bylaw has been adopted only sporadically by co-ops - in anticipation in the mid-1990's of growth in non-member income from non-regulated business units and non-operating income such as reimbursement for administrative service provided to non-utility subsidiaries; rents from real property, interest, dividends, annuities, royalties, and gains from the sales of non-utility property. Co-ops with non-utility income have a choice with respect to assignment of patronage income.

The standard co-op approach would be to assign ("allocate") non-member income (revenue in excess of costs of non-utility operations) to members of the ILEC parent cooperative. In doing so, the co-op would be required to track and assign this revenue separately, report it separately, and revolve it back to members separate from patronage capital of the ILEC cooperative. Because the revenue is derived from activities involving non-members outside the ILEC, the patronage is becomes a taxable "dividend" if returned to members. Similarly, if the outside activity involves a for-profit, c-corporation owned by the cooperative, all earnings are "dividends" when paid to the parent co-op (and passed-through to its members.) (Also see discussion of recent Revenue Ruling 2002-55 under issue 6.)

This is precisely the result afforded non-cooperatives under 196.204 with respect to the use of retained earnings. What justifies a different treatment for cooperatives? We submit that the different treatment would be arbitrary and capricious.

Issue 3: In what respects similarities between ILEC cooperatives and for-profit ILECs should influence, if at all, the accounting treatment to accorded patronage capital.

Despite the arcane requirements applicable to cooperative operations, cooperatives and investor-owned utilities (IOUs) are similar in some respects. Of relevance here: cooperatives revolve member's assigned funds, similar to (but not the same as) IOU payment of dividends on investments. (Historically, co-ops could not attract investors so members are by law the source of equity capital.) "Earnings" in excess of costs for both firms are invested by the Boards of Directors in order to grow and succeed.

Strait describes a difference between ILECs that is fundamental to the docket: telephone cooperatives are not normally stock companies, but many small for-profit companies are. Specific accounts are established to accommodate those companies and their capital stock. (Strait Response, para. 3 -7)

The classification of cooperatives' patronage capital as retained earnings (4550) will continue the legal and accounting practice that has been in place for decades for cooperatives. Unlike firms that issue stock to raise capital, cooperatives use the retains as the primary source of equity investment.

Differential treatment by the Commission of cooperatives with respect to retains is inappropriate. If the retains of the cooperatives are reclassified to account 4520, the cooperatives will be denied the use of patronage capital for investment outside the utility. This would put the cooperatives at a dramatic competitive disadvantage. Moreover, the cooperative's members, through their elected boards, will not be able to develop the new services they want through use of retained patronage.

The Commission should consider that partnerships and limited liability companies are even more like cooperatives than c-corporations. As "pass-through" entities for income tax purposes, sub-chapter S corporations, Limited liability Companies and partnerships also do not have "earnings" subject to the income tax. Income is distributed (or attributed) at the end of each fiscal year to the members of those firms. The members are taxed on the firm's net income. Similar to co-ops, the boards of directors of these firms can vote to allow the firm to retain and invest the net income, or make distributions at any time. Despite these similarities, the Commission has not considered or ordered reclassification of retains for other ILECs that are sub-S corporations, LLCs or partnership, nor should they, because all their earnings are essentially the same - retained earnings.

Issue 4: What relevance Wis. Stat. 185 should play in the accounting treatment to be accorded patronage capital?

Chapter 185 is the statute under which all Wisconsin cooperatives are organized. In relevant part, 185.45 is the "preexisting legal authority" requiring operation at cost and the return of net margins to members (a patronage dividend or "price adjustment"). Sections 185.45 (3) and (4) prescribe how net proceeds are to be assigned. Para. 5 prescribes how net proceeds may be paid (including credits) to patrons.

This underlying legal authority also requires explicit bylaws to be enacted to prescribe the apportionment and distribution of net proceeds. The statute is but one of the requirements anticipated by the bylaw in question. Other "pre-existing legal authorities" with equal binding force requiring patronage dividends include the bylaws of the cooperative, the membership agreements with members/patrons, and possibly, separate contracts with members/patrons.

We think the Commission has misread and mis-interpreted s.185.45. In the Albino letter order of December 17, 2001, Albino reaches two mistaken conclusions. First, that under 185.45(3) "net income shall [only] be distributed and paid", when in fact, paragraph 3(a) allows for reasonable reserves to be retained and *credited* to patrons; para. 3(b) provides that "all of the *remainder* shall be distributed and credited to patrons...." The ILEC cooperatives are acting within this authority when assigning , notifying patrons, retaining, revolving and eventually distributing allocated patronage. Second, the Albino letter concludes that under paragraph 185.45(4)(a) the net proceeds credited to *allocated* or unallocated surplus or reserves of the cooperative would **not** be considered patronage capital. This is wrong. Paragraph 4(a) explicitly permits any portion of the net proceeds to be credited to either *allocated* [i.e. patronage] or unallocated surplus or reserves, as long as bylaws permit doing so. (See Albino letter, Attachment A to June 4, 2002 submittal.)

With the long-established bylaw in place, nothing in s.185.45 justifies the conversion of allocated or unallocated surplus or reserves from retained earnings (1) allocated or 2) unallocated) to additional paid in capital.

Issue 5: Whether treatment or consideration accorded to patronage capital by other government agencies via legal requirements (including court cases or other directives) or external lenders influence in any way, and to what extent, the accounting treatment to be accorded to patronage capital [by the commission].

Cooperatives first became exempt from taxation in 1916. Throughout the 86 years since then, countless court cases and IRS decisions have shaped the law that applies today to telephone cooperatives under IRC 501-c (12). Much of this history and precedent is discussed in the cooperatives' submittal of June 4, 2002 (attached for reference. Also See Strait submittal, para. 9-19.)

Cooperatives have invited the RUS and the National Rural Utilities Cooperative Finance Corporation (CFC) to submit their own comments in this matter.

We note that the annual RUS Financial and Statistical Report, Form 479, filed with RUS, requires that Patronage Capital be recorded in Account 32.4550. (See instructions re retained earnings.) The RUS Mortgage and Security Agreement (which is the lending contract with telephone cooperative borrowers) requires that the account 32.4550 be used to report the equity of nonprofit organizations. (Art II, s. 15 of the agreement.) RUS auditors review the rates and finances, including debt-equity ratio, and status of patrons' accounts - all central to the financial structure and tax status of the cooperative.

The RUS (formerly the Rural Electrification Administration) has issued REA Bulletin 402-3 as guidance to borrowers on the proper policy for capital credits. The recommended bylaw contained in the bulletin, includes the following: "All such amounts [allocated capital credits] credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital." RUS (formerly REA) Bulletin 402-3 (1964) Appendix A at 8.

Issue 6: Whether the Commission's accounting treatment of patronage capital has any impact whatsoever on the ILEC cooperatives' nontaxable status for either federal or state income tax purposes.

Ten of the eleven Wisconsin ILEC cooperatives are now subject to the federal income tax by virtue of their levels of non-member income. The loss of tax exempt status arises when a telephone cooperative realizes more than 15 percent of its annual income from non-member sources or fails to operate on a cooperative basis. Nevertheless, as long as the cooperatives operate "on a cooperative basis", they are permitted to exclude the assigned patronage dividends from net income before calculating the tax. Nor is tax paid on the amounts allocated (passed-through) to patrons. The patrons themselves are not subject to tax unless they received a tax benefit from the amounts paid to the cooperative (such as a business deduction for utility expenses.) Here again, for the typical residential telephone customer, patronage allocation should be viewed as a "price adjustment" in the trade done with the cooperative during the prior year.

Regardless of non-exempt tax status, it remains absolutely essential that each cooperative continue to operate "on a cooperative basis" in order to preserve its exempt the benefit of the exclusion of patronage dividends from gross income. If the loss of cooperative status occurs (as a result of failure to pay patronage refunds from account 4550, for example) the cooperative will be taxed like a c-corporation, and its "dividends", will be taxed again when the patron in the year the patron receives them. *Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 05 (1965);* also *Rev. Rul 72-36;* also see Strait comments, para. 15, 18.

From this illustration, the Commission can see the serious consequences if the principle of operation on a cooperative basis is violated. Among other things, an immediate and significant tax increase on the cooperatives would be required.

Discussion of Recent IRS Ruling

On August 30, 2002, the IRS issues Revenue Ruling 2002-55. The ruling has no relevance to the issues in 05-US-115.

The issue before the Service was whether income of an exempt telephone cooperative from its wholly owned taxable corporation is to be treated as non-member income in applying the 85-15 income test. The corporation did not operate on a cooperative business.

The Service held that the income of the taxable corporation is not included as income of the cooperative, as long as the corporation was formed for a valid business purpose. The service further ruled that any payments of dividends which the exempt telephone cooperative receives from the taxable corporation are included as non-member income. The Service said the ruling is effective for taxable years beginning after December 31, 2002, but "taxpayers may rely on this revenue ruling for prior periods."

Since all but one of the Wisconsin ILEC cooperatives are non-exempt, this ruling would have no impact unless they were to seek exempt status. The cooperatives are already in compliance with the ruling.

Issue 7: Whether the Commission should adopt two new subaccounts 4550.1 Retained Earnings - Patronage Capital Unassigned and 4550.2, Retained Earnings - Patronage Capital assigned, and create a new account 5411, Members' Equity.

The exact language recommended for incorporation in the requested subaccounts in included as the first attachment following these comments.

It may surprise the Commission to learn that subaccounts of retained earnings for the patronage capital of cooperatives existed before January 1, 1988! See USOA for Telephone Utilities (Class C), Public Service Commission of Wisconsin, Effective January 1, 1975. (2nd attachment) The Wisconsin PSC dropped the subaccounts when it adopted the FCC revised USOA effective on January 1, 1988 We do not know why the PSC-W dropped the sub-accounts for cooperatives. Wisconsin Act 496 of 1993 was enacted, but also made no distinction. Since the time of enactment, the cooperatives have followed the use of Account 4550, and for the reasons stated above, the Commission should amend its USOA Account 4550 to create two sub-accounts for the classification of cooperative patronage capital.

The cooperatives also proposed creation of a new account in which to record Member Equity. This request was not related to the patronage capital matter, but as a "fix-up", applicable only to cooperatives, to record the membership fees collected by some cooperatives. Many co-ops no longer collect an initial membership fee from new members, but for those that do, this separate account would simplify record keeping and return of the fee when membership terminates. Creation of the account would have no effect on the 4550/4520 issue.

Following the original requests by the co-ops, the PSC opened docket 05-US-113, and the matter of account 4511 could be addressed there. Cooperatives prefer that the decision to create this account be made in this docket.

Issue 8: If patronage capital-related amendments to the USOA are adopted, what should be the effective date of any such changes. If not adopted prospectively, whether any particular past date(s) should be utilized.

The cooperatives continue to support application of the requested sub-accounts for a period of years back to January 1, 1988 (previously December 31, 1987). The reason is simply this: co-ops have followed the PSC USOA which has classified patronage capital as retained earnings continuously until the present day. (See the response to issue 6.) No change was ordered in the version adopted in 1988 (and followed to this day), although sub-accounts for cooperatives' patronage capital were dropped without any known explanation in the 1988 version. Backdating the effective date would merely constitute agreement by the PSC-W that the classification of retained earnings has been appropriate since the 1988 order.

If the commission were to order reclassification of retains to account 4520, a retroactive application to any or all existing surpluses that were built-up in the interim would be wholly unfair - essentially retro-active ratemaking. Undoubtedly, board decisions made under the past, approved accounting method, would have been different under the reclassification method.

The only cooperative known to be affected by any interim ruling on accounting is Chibardun Telephone Cooperative - as a result of the Commission decision in November, 2001. Chibardun was required to record all its accumulated retained earnings as additional paid-in capital. Chibardun's members' patronage capital, amounting to several million dollars, was booked in account 4520 at the close of FY 2001 operations. Unless the commission adopts this order, some of this capital could be lost to the members in future revolvement. The cooperative may be unable to complete some planned or partially invested competitive services in rural northwestern Wisconsin.

The notice in this docket, in footnote 4, speculates that co-ops requested a retroactive effective date for an order, intending to "immunize past subsidization activities". Such speculation is fantasy. The date was suggested because the requested change links the requested modification (new subaccounts) to the prior version of the PSC's USOA that applied until December 31, 1987. (See response to issue 7.)

The statutory rule against subsidization of non-utility activities at a level in excess of retained earnings, enacted in Act 496 of 1993 has and will continue to apply. A prohibition on cross-subsidies also no-doubt applied before Act 496.

Issue 9: Any other comments applicable to this matter.

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

(a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
(b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

(a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the cooperative. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
(b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includible in A/C 32.4550.1 Retained Earnings Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550 Retained Earnings Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

(a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
(b) Subsidiary records shall be maintained so as to show separately each class of stock.
(c) This account shall be charges with the book amount of any memberships retired.

UNIFORM SYSTEM OF ACCOUNTS

FOR

TELEPHONE UTILITIES
(Class C)

Prescribed by

PUBLIC SERVICE COMMISSION
OF WISCONSIN

Effective January 1, 1975

conclude that the definition of each class of telephone utilities should be changed in recognition of present-day conditions.

Conclusion of Law

THE COMMISSION CONCLUDES:

That it has jurisdiction under section 196.06, Wisconsin Statutes, to prescribe and amend uniform accounting systems for those utilities subject to its jurisdiction.

Order

THE COMMISSION ORDERS:

1. That every Class C telephone utility as defined in the Uniform System of Accounts herewith adopted, subject to the jurisdiction of this Commission shall, effective January 1, 1975, keep its accounts fully and completely in accordance with the Uniform System of Accounts attached hereto and made a part hereof.

2. That the Uniform System of Accounts heretofore prescribed by the Commission in the above-entitled dockets, as modified by general order dated April 4, 1954, be and the same are hereby further amended, effective January 1, 1975, so as to define the various classes of telephone utilities as having the following amounts of annual gross operating revenues:

Class C - Under $200,000

Class B - From $200,000 to $600,000

Class A - In Excess of $600,000

Dated at Madison, Wisconsin, October 17, 1974

By the Commission.

John F. Goetz
Secretary

10. Retained Earnings

180	Retained Earnings Reserved
181	Unappropriated Retained Earnings
181.4	Patronage Capital Assignable
181.5	Patrons' Capital Credits Assigned
181.6	Gain in Retirements of Capital Credits

B. Separate subaccounts shall be maintained under such titles as will designate the purpose for which each reserve recorded hereunder was created.

181. UNAPPROPRIATED RETAINED EARNINGS.

A. This account shall include the undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includible in the other accounts appropriate for inclusion of stockholders' equity.

B. The retained earnings analysis accounts (400 to 416, inclusive), wherein are recorded all entries to retained earnings during the year, shall be closed into this account at the end of the year.

C. This account shall be so maintained as to show in the annual reports to the Commission a complete analysis of all entries to this account.

181.4. PATRONAGE CAPITAL ASSIGNABLE.

This account shall include for nonprofit organizations all amounts transferred from operating margins, nonoperating margins, and other margin accounts which are assignable to individual patrons.

181.5. PATRONS' CAPITAL CREDITS ASSIGNED.

This account is used by nonprofit organizations to record the patronage capital credited to individual patrons. The balance in this account is to be supported by a capital credits ledger showing the amount of capital furnished by each individual patron, and the amount of such capital returned to him.

181.6. GAIN IN RETIREMENTS OF CAPITAL CREDITS.

A. The use of this account by nonprofit organizations is to reflect any gain resulting from retirement of patronage capital of individual patrons at less than 100% of the stated value. The portion of patronage capital not returned to patrons shall be debited to account 181.5, Patrons' Capital Credits Assigned, when this account is credited.

B. The account shall also include amounts representing patronage capital for which return to patrons has been authorized but who, after a reasonable attempt, cannot be located. A record should be made of all credits not returnable to patrons for lack of address, or other reasons, in the event subsequent claims are presented by these individuals.

THOMAS M. STRAIT

Thomas M. Strait, one of the founders of the Washington Utility Group, specializes in the areas of utility taxation and finance, with particular expertise in taxation of rural electric and telephone cooperative utilities. Over the past seventeen years, he has gained a national reputation for providing cooperative tax and financial advisory services of the highest quality.

He has provided tax consulting services to a broad array of clients within the electric, gas, telephone, and water/waste segments of the utility industry. In addition to representing clients before the Internal Revenue Service (IRS) at the local, regional, and national levels, he has directed engagements for providing strategic tax and financial planning, managing tax audits, and requesting tax rulings from the National Office of the IRS.

He has been a frequent speaker at tax conferences sponsored by industry trade associations at the national and state levels including the National Rural Electric Cooperative Association, the National Telephone Cooperative Association and Public Utility Reports. Further, Mr. Strait has been an instructor of tax and financial topics for the Management Exchange course, "Fundamentals of Utility Finance and Accounting," for the Rural Utilities Service's biannual "Accountant's Seminar", and for Ernst & Young's "Federal Taxation of Rural Utility Cooperatives," and "Taxation of Telecommunications Companies."

In 1991 Mr. Strait was appointed by the Secretary of Energy to the Advisory Committee on Renewable Energy and Energy Efficiency Joint Ventures. More recently, he was appointed to the editorial advisory board for Public Utility Reports' *PUR Utility Weekly*.

Wisconsin Federation of Cooperatives

131 West Wilson Street, Suite 400, Madison, WI 53703
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June 4, 2002

Ms. Lynda Dorr, Secretary
Public Service Commission of Wisconsin
P. O. Box 7854
Madison, WI 53707-7854

In re: Accounting Treatment for Patronage Capital of Telecommunications Cooperatives - File TELACCTG

Dear Ms. Dorr:

The Wisconsin Federation of Cooperatives (WFC) files this letter in the above-referenced matter to help clarify the sometimes-confusing accounting and economic theory and practices of cooperatives. We have observed the considerable amount of argument, including recent efforts to change Chapter 196, to accommodate the established method by which cooperatives capitalize ongoing and new ventures. Our intent is to explain how cooperatives operate financially under various laws (primarily the Internal Revenue Code (IRC)), the Rural Utilities Service, and generally accepted accounting principles and thereby support the cooperatives' requests for a modification of PSC 05-US-102 relating to the PSC Uniform System of Accounts (USOA).

Summary

- The Public Service Commission of Wisconsin (PSC) directive (David Albino letter order of 12-17-01 (Attachment 1) to classify "patronage capital" as "additional paid-in capital" is inconsistent with long-established cooperative accounting and tax law.

- The reclassification will deprive the cooperatives of their primary source of equity capital. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.

- The RUS (formerly REA) recommended the bylaw language at least as early as 1964 in its guidance to telephone cooperatives. REA Bulletin 402-3 (1964) (Attachment 2). Longstanding caselaw and tax court rulings (cited below) also are the legal foundation for operation on a cooperative basis. Adopting the changes suggested by the cooperatives will keep PSC rules in harmony with overriding federal tax law, RUS requirements, and Chapter 185, Wis. Stats. (Attachment 3.)

- It is unreasonable to suggest, as the letter order does, that cooperative adopt new bylaws to accommodate the PSC's interpretation of cooperative accounting. The bylaws are rooted in a complex web of law and federal agency rulings. (Bylaw changes also require great time and expense to each cooperative.)

- Unless the letter order is modified, the cooperatives will be subjected to extraordinary regulation by the PSC which a) jeopardizes the ability of the telecommunications cooperatives to operate financially, and b) puts all telecommunications cooperatives at a competitive disadvantage.

- WFC supports the proposal filed by the telecommunications cooperatives in response to Mr. Albino's letter. They ask the commission to create new subcategories of "retained earnings" for a) assigned and b) unassigned patronage capital. The suggested changes will preserve the traditional source of equity for these cooperatives, and make a rational distinction between classes of retained earnings of investor-owned firms and cooperatives. (Cooperatives do not have retained earnings in the same sense as investor-owned corporations because margins (revenues in excess of costs) are allocated to patrons. Some part may be paid currently; the remainder is used as equity capital pending payout at a later time. Importantly, the change requested by the cooperatives will protect the interest of patron-ratepayers in reasonable rates, and will protect competitors' interest in prohibiting unfair subsidies.

Background

Wisconsin Act 496 of 1993 failed to make any distinction for telecommunications cooperatives with respect to their patronage capital. Most cooperative tax and other authorities use "margin", "patronage capital", "capital credits", "hold-back", "per unit retains", "allocated reserve" and other similar terms almost interchangeably with "retained" income or earnings of the cooperative. However this letter will show that underlying economic theory of "operation on a cooperative basis", under federal tax law, imposes strict limitations on the use of "members' equity".

In the letter order, the PSC-W directed telecommunication cooperatives to classify patronage capital in Account 4520 as "Additional Paid-In Capital". The effect is to treat allocated patronage capital of cooperatives as permanent paid-in-capital, which it is not. In fact to consider it paid-in-capital would contradict the basic principles of cooperatives, in that the cooperative has an obligation to return the "allocated"[1] patronage to the patrons.

In response, the cooperatives have requested the creation of two new USOA sub-accounts for "retained earnings" which would apply only to cooperatives.

Legislation, Rule or Accounting System Change

In 2001-02, the cooperatives lobbied to amend Chapter 196 with respect to the treatment of retained earnings under s.196.204 (1), Stats. This effort became entangled with "deregulation" efforts, and the legislation failed to pass. The instant case is much narrower, was not the subject of legislation, and cannot wait for a legislative "fix" to cure the effects of Mr. Albino's letter.

The commission can accomplish the change required by the cooperatives through administrative means - a change in the Uniform System of Accounts to accommodate the conventional practice by cooperatives to use allocated "margins" in continued operation of the cooperative. As a change in the USOA, the requested change does not constitute a rule under Chapter 227.01(s).

Why The USOA Classification of Patronage Capital As "Paid-In Capital" Is Inappropriate for Cooperatives

The letter order of the commission would force telephone cooperatives to keep a second set of books to satisfy the PSC requirements. As discussed in more detail below, RUS rules and documents require accounting for patronage capital in account 32.4550, and doing otherwise would raise audit questions. Accounting for patronage capital as "paid-in capital" would also pose a serious risk of loss of cooperative status under IRS rules. Those rules (detailed below) require the return of capital to the member/patron as one of the central features of operation on a cooperative basis. Therefore, the cooperatives would have no choice but to maintain a second set of books - certainly an unreasonable requirement.

A short excursion into tax law and cooperative economic theory is necessary to illustrate why certain cooperative accounting practices are critical and should not be altered by PSC decree. The IRS code, the tax court and many complex opinions and rulings which

[1] "Allocation" is a legal concept central to this discussion, and to the impact of the PSC letter order. As a legal concept, allocation includes distributions of cash, merchandise, issuance of patronage certificates or other instruments, letters of advice or in any other manner of disclosure to a patron the dollar amount apportioned on the books of the association for the account of the patron. (Paraphrasing 26 C.F.R. Part 1, Sec.1.522-b(b)(3). The language was historically interpreted to require actual notice to each patron, but the IRS has subsequently written that actual notice may not be necessary, but as long as the cooperative's records permit the determination, at any time, each member's rights and interest in annual savings and assets acquired with such savings. Also see Rev. Rul. 72-36, 1972-1 C.B. 151.

flow from tax law form the basis for co-op accounting practices. (Similarly, tax law sets most of the legal boundaries for partnerships, limited liability companies and other pass-through business organizations.) Tax law prescribes accounting practices that will meet certain required cooperative tax principles when operating on a cooperative basis. Rev. Rul. 78-238, 1978-2 CB 161. "Three guiding principles" of cooperative economic theory include (1) subordination of capital, (2) democratic control by the members, and (3) proportional allocation of margins on the basis of patronage. BNA Tax Management Portfolio 229-2nd, Taxation of Cooperatives, p. A-3, (1999). (See Attachment 4.)

Through a number of alternative means, every cooperative must allocate (i.e., place in the members' names for later payout) margins *pro rata* to the members/patrons from whom it was derived in order to preserve tax exempt status and avoid double taxation of the income. Rev. Rul 72-36, 1972-1 C.B. 151. (Attachment 5.) Simultaneously the cooperative must capitalize its operations with members' equity. To skip the unworkable burden of literally paying out, then re-collecting capital from members, state statutes (See. 185.45, Wis. Stats.) prescribe methods to using some or all margins for a period of years, with actual payout ("revolvement") when the co-op's finances permit the refund of the patronage capital. The Commission's order will interfere with these legally prescribed procedures. Puget Sound Plywood, Inc., 44 T.C. 305, 322 (1965). (Also see Discussion section below.)

1. The accounting treatment ordered by the commission does not fit the cooperative business model. Re-classification of allocated (but "retained") patronage refunds as additional paid-in capital (per the PSC letter order) causes members to further capitalize the cooperative on a permanent basis and give up the right to their patronage refunds at the end of the cooperative's established revolvement cycle. Cooperatives may lose their special Cooperative status for income tax purposes by treating retained allocated margins as additional paid-in capital. *Id.* at 305, 323. Also see REA Bulletin 402-3. (Attachment 2.)

2. The capital in account 4520 is reserved for the utility and its operations and expansion, not necessarily the diversified activities where the capital is desired by the members to further serve the members. In other words, the cooperative utility recovers all its normal operating expenses through its rates, so additional capital is not needed there. Instead, the members, through their elected boards, may decide to develop diversified activities to serve the members. Rev. Rul, 72-36. Patronage capital, classified as "retained earnings", is the only source of member equity for these purposes, yet the PSC proposes to reclassify these funds and block their use. For that reason, Account 4520 - Additional Paid-In Capital, is inappropriate.

3. The RUS imposes guidelines on utilities that borrow federal funds in order to assure repayment of federal loans. The PSC order alters the financial structure of the cooperatives for purposes of federal accounting, and jeopardizes the good standing of the cooperative with the RUS. Example, the annual RUS Financial and Statistical Report,

Form 479, filed with RUS, requires that Patronage Capital be recorded in Account 32.4550. (See instructions re retained earnings.) Example: the RUS Mortgage and Security Agreement (which is the lending contract with telephone cooperative borrowers) requires that the account 32.4550 be used to report the equity of nonprofit organizations. (Art II, s. 15 of the agreement.) Example: RUS auditors review the rates and finances, including debt-equity ratio, and status of patrons' accounts - all central to the financial structure and tax status of the cooperative.

4. The RUS (formerly the Rural Electrification Administration, with essentially identical rules for telephone cooperatives) has issued REA Bulletin 402-3 as guidance to borrowers on the proper policy for capital credits. The recommended bylaw contained in the bulletin, includes the following: "All such amounts [allocated capital credits] credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital." RUS (formerly REA) Bulletin 402-3 (1964) Appendix A at 8.[2]

5. The ordered reclassification of funds has a second effect that was the focus in Chibardun. The measure of retained earnings under the limitation of s.196.204(1) ("Except for retained earnings, a telecommunications utility may not subsidize....") limits cross-subsidization by the regulated entity. Reclassification will limit, if not eliminate, the retains of the telephone cooperatives for purposes of section .204.

6. The PSC order contravenes Chapter 185, Wis. Stats., the IRS Code, RUS guidance and loan documents, and long-standing cooperative accounting conventions.

Discussion

We understand that some telecommunications cooperatives have enacted a bylaw which seems to treat patronage capital as if paid to the patron, then immediately deemed to be furnished by the member to the cooperative as "corresponding amounts for capital" to the cooperative. This form of bylaw does not transform allocated reserves to "paid-in capital" in the view of the Rural Utilities Service (RUS), or IRS. (See below.) Indeed, the RUS has recommended this form of bylaw for telephone cooperatives for the furnishing and retirement of capital. REA Bulletin 402-3.

This bylaw is intended to comply with the requirement for a "pre-existing legal obligation" to return or allocate margins. Farmers Cooperative Co., 33 T.C. 266, (1959). The cooperative's bylaw constitutes the "pre-existing legal obligation" to refund or allocate margins to patrons in order to exclude margins from taxable income. Another primary legal obligation to refund or allocate margins is plainly stated in Chapter 185.45,

[2] The language cited was not the subject of the bulletin, but the bulletin is illuminating. Due to a lack of time we have been unable to trace the origin of the quoted language.

Wis. Stats. Land O' Lakes, Inc. v. U.S., 470 F.Supp. 238 (D.C. Minn., 1979). Under that section, in para. (3), a cooperative shall distribute "net" income to patrons under two alternate methods. Each method permits the hold back of proceeds, and the payout of the remainder to patrons. Under the second method (para. (4), if the bylaws provide, any of the net proceeds may be "credited to allocated of unallocated surplus or reserves," and the remainder shall be paid to patrons.

This treatment mirrors the design of federal tax law: allocate margins to members as income to the patron, take the deduction in the current year, "retain" and use the allocated equity for the cooperative's purposes - subject to future pay-out to members on a pro-rata patronage basis. (The taxpayer reports the capital credits when received as income in a later year.) The allocation of margins distinguishes a cooperative from that of a corporation in that shareholders of a corporation share in income to the extent of their shares and patrons of a cooperative share in income to the extent of their purchases from the cooperative. This allocation process provides the "record" of the obligation to the patron similar to a preferred stock dividend that is cumulative is an obligation to a corporation. Rev. Rul. 72-36.

The PSC Order Is Unfair To Cooperatives Alone

The PSC-ordered accounting revision has the effect of singling-out cooperatives, and depriving them of equity capital. By labeling allocated patronage capital as "additional paid-in capital", the funds are restricted to use by the utility. Non-utility purposes of telecommunications cooperatives would not have access to their members' equity - again contravening fundamental cooperative principles. This dissimilar treatment of cooperatives places them at a competitive disadvantage in Wisconsin in serving their own members. The commission order would restrict expansion and modernization of rural services by the very firm that is in the best position to serve rural patrons - the firm which patrons have capitalized and belong, the firm which gives its patrons a direct voice in operation and governance of their enterprise.

Unlike investor-owned firms that can issue additional stock, or pay less in dividends to boost retained earnings, cooperatives have no other ready source of equity capital for use in diversification. (The issuance of stock by the cooperative is legally possible, but may place the co-op in a dramatically different legal, tax and economic position than it has chosen.)

More Background: An Explanation of "Patronage Capital" And Its Use by the Cooperative

Patronage refunds might be paid to members from margins earned in the current year, but normally refunds are based on patronage in a prior year (i.e., the first year in the revolvement cycle.) The years between allocation of margins and eventual payout are called the "revolvement period". Every co-op would like to minimize the revolvement cycle in order to reward members for their patronage as soon as possible, but in many cases it takes many years.[3] The IRS prohibits the "improper accumulation of retained funds, but the funds retained can be used for meeting current losses and expenses, retiring indebtedness, acquiring assets, expanding the services of the organization and maintaining reasonable reserves. Rev. Rul. 72-36.

Many factors influence the co-op's ability to pay refunds to members: the relative profitability of the co-op, the level of margins above "operation at cost", the level of competition in reducing sales and or prices, weather (in fuel or electric sales, for example), or broader economic conditions (the farm economy, for example.) It cannot be overlooked that cooperatives were frequently created in places and circumstances where investor-owned firms would not venture due to high risk or low profit. This is certainly true for utility cooperatives: it is the very reason why tax laws accommodate "not-for-profit" firms, and why federal low-interest loans are available for firms in rural areas.

The best illustration of the foundation of a cooperative, especially telecommunications and electric cooperatives in Wisconsin, is to consider their history. When first created in the 1930's and 1940's, Wisconsin's rural residents simply could not obtain utility services from investor-owned firms, nor could they obtain conventional loans to capitalize costly infrastructure. Rural people raised some capital with cooperative membership fees, and leveraged this funding with low interest loans from a sympathetic federal government. The membership fees were not an investment in a distant enterprise - membership and subsequent patronage literally purchased an ownership interest in the cooperative. Inherent in the law of cooperatives is that membership fee and sales revenue from member-patrons will continue to finance the firm. Today this may seem to be a poor "investment". In earlier days, the members were creating their own economic infrastructure and sources of new products and services where none existed. And when it could (in a good year), the co-op would "retire" and pay out capital credits from its earlier years of operations. When a patron dies, his/her right to capital credits will continue to be paid, either in a lump sum (often at net present value) or in annual increments to the heirs or estate. (Again, within legal limits. See Rev. Rul 72-36, and REA Bulletin 402-3.) This financial foundation of cooperatives has its limitations today, when consumer

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[3] See the RUS Bulletin 402-3 for some discussion of this. Every cooperative determines its own period of revolvement, set by the Board of Directors within legal limits, to serve capital needs. Ideally, the period of revolvement is eight or fewer years, and we believe several Wisconsin telecommunications cooperatives use eight years. However, many cooperatives have a 20-year revolvement of members' capital, and some may <u>never</u> have paid a patronage refund because of unprofitability. <u>Fundamental to understanding the cooperative form of business is the fact that member's equity capital IS NOT an investment as we may think of it in today's economy. Member/equity capital is the member's ownership share of the cost to create and operate the cooperative on an ongoing basis.</u>

expectations are changing. However, in many areas of Wisconsin and the United States, cooperatives operating "at cost" remain as the only willing provider of affordable high quality services to rural people.

The Effect on Ratepayers and Competitors

The statutes grant ratepayers of the telecommunication cooperative their rights to have both a direct voice (annual meeting, special meetings, voting directly or by mail, and otherwise) and a representative voice (board of directors) in the operation of their utility. s.185.12, .13, .31, .32, Stats. In addition, Chapter 196 also protects their interests. Therefore it is difficult to argue that members/ratepayers of the cooperatives are not well-served by the activities of their cooperative in both its utility and non-utility activities. Attendance at meetings of these cooperatives presents every member the opportunity to voice dissent over operations, diversification, and any other activity of the cooperative.

Chapter 196 also protects competitors from unfair competition. Some competitors may argue that the requested clarification would "tilt the playing field" to the advantage of cooperatives. This argument has no merit: as described above, telecommunications cooperatives are hobbled by the current one-size-fits-all treatment of "retained earnings." The limitation in s.196.204 simply fails to recognize that cooperatives have no retained earnings - all revenues ("margins") that exceed costs are assigned to members and are eventually paid out to members in accord with other law._ (It is this fact which necessitates the revised accounting order which the cooperatives have requested.)

Firms which protest that cooperatives enjoy unfair advantages are welcome to operate on the same cooperative, "at cost" basis. They never opt to do so because they normally serve areas more densely populated than the regions served by cooperatives.

What the Telephone Cooperatives Have Proposed

The telecommunications cooperatives, all members of WFC, have submitted letters proposing creation of two new subcategories of Account s.32.4550, and a new account for member's equity. To accomplish these changes in accord with the authorities cited above, the telephone cooperatives have proposed creation of:

- sub-account 32.4550.1 Retained Earnings - Patronage Capital Unassigned
- sub-account 32.4550.2 Retained Earnings - Patronage Capital Assigned
- creation of a new Account 32.4511 - Members Equity

Account 32.4550 for "retained earnings" is retained for "patronage capital" because there is no other account to classify it logically. Creation of sub-accounts will assure continued compliance with RUS and IRS requirements.

Patronage capital of cooperatives must continue to be classified as retained earnings for the purpose of the measurement under s. 196.204 (1), where the level of retained earnings are the limit of permitted subsidies of non-utility activities.

The cooperatives have provided the details of how these accounts will meet PSC objectives, while permitting them to continue to operate in compliance with all legal authorities.

Conclusion

The telephone cooperatives have adopted accounting customs based on rules of the RUS and the IRS, the federal laws which created cooperatives and sanction "operation on a cooperative basis," including all the complexity which that phrase represents. The PSC should accommodate the longstanding accounting and tax conventions, manifest in the varied bylaws of the cooperatives, by creating two sub-accounts for the classification of retained earnings of cooperatives. Doing so would keep PSC rules in harmony with overriding federal tax law, RUS requirements, and state law (Ch. 185). It would be unreasonable to order cooperatives to adopt new bylaws to accommodate the PSC's interpretation of cooperative accounting. It would also be unreasonable to force the cooperatives to keep a second set of books for PSC purposes, as would be necessary to comply with federal requirements.

WFC requests that the PSC act under its authority to administer a uniform system of accounts (Docket 05-US-102) and adopt the changes requested by the telephone cooperatives.

Thank you for your consideration.

Sincerely,

W. J. Day

Warren J. Day
Attorney, Wisconsin Federation of Cooperatives

Attachments

CC K. Klingbeil, PSC
M Varda, PSC
All Telephone Co-op General Managers

Public Service Commission

Ave M. Bie, Chairperson
Joseph P. Mettner, Commissioner
Robert M. Garvin, Commissioner

610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

December 17, 2001

TO: Wisconsin Incumbent Local Exchange Telecommunications Cooperatives — **Reply Required**

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives — File TELACCTG

In its order dated November 16, 2001, in *Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations*, docket 1090-TI-100, the Commission concluded that Chibardun Telephone Cooperative, Inc.'s patronage capital is not part of account 4550, Retained Earnings, within the meaning of Wis. Stat. § 196.204(1), but rather should be classified in account 4520, Additional Paid-in Capital, based on the distributed nature of patronage capital under that cooperative's bylaws.

By order dated October 1, 1987, in docket 05-US-102, *In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities*, the Commission adopted the following language for subsection (a) of account 4550, effective January 1, 1988:

> (a) This account shall include the undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includable in the other accounts appropriate for inclusion of stockholders' equity.

In effect, the Commission's order in docket 1090-TI-100 clarifies that patronage capital does not qualify as an "other transaction" includable in retained earnings under subsection (a) of account 4550.

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The above accounting treatment should be implemented by all incumbent local exchange telecommunications cooperatives in Wisconsin. At the present time, the following telecommunications cooperatives are operating in the state:

1. Chequamegon Telephone Cooperative, Inc.
2. Chibardun Telephone Cooperative, Inc.
3. Citizens Telephone Cooperative, Inc.
4. Cochrane Cooperative Telephone Co.
5. LaValle Telephone Cooperative, Inc.
6. Marquette-Adams Telephone Cooperative, Inc.
7. Nelson Telephone Cooperative
8. Richland-Grant Telephone Cooperative, Inc.
9. Tri-County Telephone Cooperative, Inc.
10. Vernon Telephone Cooperative
11. West Wisconsin Telcom. Coop. Inc.

Telephone: (608) 266-5481
Home Page: http://www.psc.state.wi.us
Fax: (608) 266-3957
TTY: (608) 267-1479

Consistent with the Commission's finding in docket 1090-TI-100, each cooperative should reclassify its patronage capital to account 4520, Additional Paid-in Capital, by December 31, 2001, and reflect such classification in its 2001 incumbent local exchange carrier annual report to be filed with the Commission on or before April 1, 2002. The reclassification is consistent with Wis. Stat. § 185.45(3), stating that "[u]nless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not." A cooperative's articles or bylaws may provide, however, that any of the net proceeds be credited to allocated or unallocated surplus or reserves of the cooperative, in which case such net proceeds would not be considered patronage capital. *See* Wis. Stat. § 185.45(4)(a).

Please confirm by letter that this change is being made. If a cooperative believes that all or a portion of its patronage capital does not qualify for classification in account 4520, that entity shall inform the Commission of the particulars constituting alternate classification prior to the closing of that entity's books for calendar year 2001.

If you have any questions concerning the above-specified accounting treatment for patronage capital by telecommunications cooperatives, please contact Kevin Klingbeil at (608) 267-9504.

Sincerely,

David Albino
Administrator
Telecommunications Division

DA:KHK:tmg:t:\ss\letter\patronage cap acctg ltr 1201

cc: Ray Riordan, Executive Vice President, Wisconsin State Telecommunications Association, Inc. (WSTA)
Gerald A. Ringlund, Chairman, WSTA Accounting Committee

WFC Attachment 2

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration

March 5, 1964

TO : Boards of Directors of Electric and Telephone Cooperatives

SUBJECT: Capital Credits and Related Consumer Benefits

REA has made important changes in its capital credit recommendations. We believe these merit the careful attention of your cooperative. These changes have been developed with the excellent help and cooperation of representatives from NRECA and NTCA. The basic objective behind these changes is to encourage active support and participation of member patrons in the affairs of the cooperative and to provide them with maximum benefits from its operation. These changes are set forth in detail in a revised REA Bulletin. A summary of these changes and the reasons why they are being made follows.

The unique position of electric and telephone cooperatives in the field of utility service is inescapably dependent upon their inherent characteristics as consumer-owned, nonprofit organizations. Their rightful claim to exemption from the usual pattern of utility regulation is based essentially on the fact that the consumer, the owner and the equity investor are one and the same, and consequently there are not the usual third party rights that require protection by regulatory agencies. Their income tax treatment is based on the fact of cooperative, nonprofit, operation.

It is important to preserve, within reasonable administrative limits, the essential identity of consumer, owner and equity investor. The revolving of capital on a systematic first in, first out basis provides an equitable method whereby each patron furnishes for a period of time his fair share of the capital needed by the cooperative and then has it returned to him as new capital is supplied in subsequent years. This results in a very desirable situation in that to the maximum possible extent the capital will be owned by the current member-patrons who are primarily concerned with the operations of the cooperative. Their active support and participation are of vital importance to the continued success of the cooperative as a member-owned and controlled enterprise.

Clear recognition of the nature of capital credits, including actual retirement as it is deemed proper, is also a critical factor in maintaining the essential position of the cooperative as a nonprofit organization.

The bylaws of a number of cooperatives provide that no retirements shall be made if after the retirement the capital would be below 40 percent of total assets. In view of the comprehensive financial planning by cooperative borrowers, this bylaw net worth provision is considered unnecessary and may be in conflict with their current objectives. REA therefore recommends the elimination of the net worth restriction on retirements from the capital credit bylaw. A number of borrowers have already eliminated this provision.

The amount and timing of capital retirements should be determined by each board on the basis of the cooperative's overall financial plan, developed as recommended in REA Bulletins on financial planning. (REA Bulletin 105-4 dated May 12, 1960, is cancelled and a revision will be issued shortly.) By using the financial plan, the board can ascertain what retirements of capital are consistent with the current objectives of the cooperative, including those relating to working capital, reserve funds, rates, and net worth.

The revised bylaw provides that the so-called non-operating margins not needed for offsetting deficits will be included with the amounts furnished as capital and allocated to the patrons. The allocation of non-operating margins in this manner increases the patrons' capital credits, reduces their cost of service, and clearly establishes the interest of each patron in the cooperative's net worth.

The offsetting of deficits or losses against non-operating margins is recommended in order to avoid the carrying of deficits indefinitely on a cooperative's books. Up to this time any deficits incurred, usually during the early years of operation, have remained on the books as a separate item notwithstanding the accumulation of net worth in later years. The revised bulletin now provides an orderly method for offsetting deficits. These offsets will not affect the cash position or change the net worth of the cooperative.

The attached REA Bulletin 102-1 (Electric) and 402-3 (Telephone) and the accompanying capital credit bylaw provisions were submitted to the Internal Revenue Service. It has advised that "the information and recommendations set forth in the Bulletin and the proposed bylaw provisions do not appear to be in conflict with the position of the Service as based on applicable provisions of the Internal Revenue Code and Regulations."

In our judgment these capital credit recommendations provide a sound basic relationship between your cooperative and its member-patrons concerning the furnishing and retirement of capital. They deserve careful consideration by your cooperative. REA personnel will be glad to meet and discuss with your Board any aspects of the new bulletin and bylaw on which you desire more information.

Administrator

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration

March 5, 1964
Supersedes 8/28/59*

REA BULLETIN 102-1 (Electric)
REA BULLETIN 402-3 (Telephone)

SUBJECT: Capital Credits - Consumer Benefits

I. Purpose: To set forth recommendations for electric and telephone cooperative borrowers concerning capital credits and related consumer benefits.

II. General:

A. The Rural Electrification Administration and its cooperative borrowers have a special concern that the cooperatives operate on a non-profit basis and provide maximum benefits for their consumers. Non-profit operation also facilitates the furnishing of area-wide dependable service at the lowest possible cost in keeping with the objectives of the Rural Electrification Act.

B. Effective bylaws, policies and practices concerning capital credits are essential in providing maximum consumer benefits and in encouraging active member participation in a cooperative's affairs.

C. Borrowers are responsible for informing REA of changes in bylaws, policies or practices concerning capital credits, including proposed general retirements of capital or other cash distributions to patrons. (See REA Bulletin 100-2: 403-3)

III. Policy and Recommendations:

A. REA recommends that each cooperative borrower operate under capital credit bylaws whereby all amounts received in excess of losses, costs and expenses will be included in the patrons' capital credit accounts. The bylaws should clearly establish an agreement between the cooperative and its members and patrons that:

1. amounts paid in excess of costs and expenses of providing service are furnished as capital;

2. such amounts will be determined annually on a patronage basis and credited to a capital account for each patron;

*REA Bulletin 102-1

3. all other amounts received by the cooperative from its operations in excess of costs and expenses will be (a) used to offset any losses incurred during the current or any prior fiscal year and (b) to the extent not needed for that purpose, allocated on a patronage basis and included as a part of the capital credited to the accounts of patrons;

4. each patron will be notified annually of the amounts credited to his capital account; and

5. capital credited to patrons will be returned to them on a revolving basis when the board determines that the financial condition of the cooperative will not be impaired thereby.

B. The amount and timing of capital credit retirements should be consistent with REA mortgage requirements and the cooperative's overall financial plan developed as recommended in REA Bulletins on financial planning. Particular attention should be given to such matters as working capital, reserve funds, rates, financing capital additions, and net worth.

C. Members and patrons should be given full information concerning capital credits to further their understanding and support of the cooperative.

D. The attached material includes appropriate bylaw provisions and additional information concerning the recommendations set forth above.

Administrator

Attachment
Appendix A

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APPENDIX A
CAPITAL CREDITS

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Purpose: The appendix provides information and guidance to cooperative borrowers concerning capital credits and related consumer benefits as recommended in REA Bulletin 102-1: 402-3. It includes:

1. A discussion of REA recommendations for establishing effective capital credit bylaws, policies and practices to assure non-profit operation and provide maximum benefits to consumers, and

2. A recommended capital credit bylaw provision.

Capital Credit Retirements: Capital credits should be returned to patrons on a revolving basis as soon as it is determined that the overall financial condition of a cooperative permits. Capital credit retirements on a systematic, continuing plan are basic to good cooperative functioning. Revolving the capital of a cooperative -- retiring the older capital as new capital is supplied -- encourages more active support and participation in the cooperative's affairs by present members. This revolving process means that to the maximum possible extent the capital will be owned by the current member-patrons who are vitally interested in the operations of the cooperative. Retirements of capital credits constitute tangible evidence to members and patrons that their cooperative is being operated on a non-profit basis and for their maximum benefit.

The bylaws of a number of cooperatives provide that no retirements shall be made if after the retirement the capital would be below 40 percent of total assets. In view of the comprehensive financial planning by cooperative borrowers, this bylaw net worth provision is considered unnecessary and may be in conflict with their current objectives. REA therefore recommends the elimination of the net worth restriction on retirements from the capital credit bylaw. A number of borrowers have already eliminated this provision.

The determination by the board as to the amount and timing of capital credit retirements should be made on the basis of the cooperative's overall financial plan developed as recommended in REA Bulletins on financial planning. Particular attention should be given to such matters as working capital, reserve funds, rates, financing capital additions, and net worth. The board thus determines that any retirements of capital credits will not impair the financial condition of the cooperative.

REA recommends that retirements of capital credits be made on a revolving basis. The board may retire all or any portion of the credits for a particular year but the oldest outstanding credits would be retired first and thereafter succeeding years' credits would be paid off in order.

The "first-in, first-out" principle for retiring capital credits is recommended because it provides a systematic and equitable method for revolving capital. There may be unusual circumstances where a cooperative may want to consider a modification of the "first-in, first-out" principle. In such isolated instances, borrowers are cautioned to have a thorough legal analysis made in order to determine the extent of possible interference with any vested rights of consumers. Where a cooperative, after such an analysis, finds there are compelling reasons to modify the revolving basis in order that all current patrons may participate in the return of capital credits, the last sentence of the 3d paragraph of Section 2 of the "Non-Profit Operation" article of the bylaws might be changed to read as follows:

> "Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the cooperative being first retired, provided, however, that beginning with the year______, cash made available for retirement in any year may be used to retire capital furnished by all patrons during the most recent fiscal year subject to the requirement that at least fifty per centum (50%) of such cash shall be applied to the retirement of the oldest outstanding capital credits as hereinabove provided."

Retirements of capital by a cooperative borrower are subject to REA mortgage requirements. It is important, therefore, that each cooperative borrower determine that any proposed retirement is consistent with applicable mortgage provisions.

If a cooperative has not always operated under capital credits, a determination of the rights of members and patrons under pre-existing bylaws should also be considered. The disposition of margins and the rights, if any, of members and patrons in margins would normally be governed by the provisions of the bylaws in effect at the time the margins were received. Some cooperatives, at the time they adopted capital credits, took appropriate corporate action to assign and credit existing margins on an equitable basis to their members and patrons, and elected to treat such margins as patronage capital subject to the same rights and limitations as patronage capital furnished under the new capital credit bylaw. An analysis of any such corporate actions or former bylaw provisions would seem advisable before authorizing general retirements for a particular year or years.

Deficits and Non-Operating Margins: Under capital credits, amounts paid by patrons in excess of costs and expenses of providing service are paid in as capital and are credited to the capital accounts of the patrons. Patrons' capital accounts are credited with the amounts of capital paid in each year even though deficits have been incurred during past years. The bulletin (paragraph III A 3) recommends that all other amounts received by the cooperative from its operations in excess of costs and expenses, usually referred to as "non-operating margins," be allocated to patrons on a patronage basis to the extent that such non-operating margins are not needed to offset any losses incurred during the current or prior years.

Before any allocations of non-operating margins are made, losses should be deducted from these margins. This will enable the cooperative to (a) offset deficits in an orderly manner, and (b) account on a patronage basis to its patrons for all amounts received from its operations in excess of costs and expenses. This means that any deficits will be systematically offset by non-operating margins and the patrons will always be credited with the capital they furnish the cooperative together with other allocable amounts. This furthers the objective of providing patrons with maximum benefits from the overall operation of the cooperative.

Non-operating margins arise principally from interest on Government bonds and savings accounts in banks and building and loan associations. Since a cooperative needs to maintain adequate funds for working capital and reserves for the conduct of the business, such as are recommended by REA in Bulletin 1-7: 300-5, it is only reasonable and in the best interests of both the cooperative and its patrons that an interest return on the funds be obtained until such time as the funds are actually used. Inasmuch as these activities are a normal part of operations and are merely incidental to the primary purpose of furnishing electric or telephone service, it is desirable to assign such amounts to patrons' capital accounts on a patronage basis. This increases the consumer benefits from the overall operations of the cooperative.

There may also be other miscellaneous amounts received by the cooperative which may not be classified in the accounts as non-operating margins. To the extent that there is a practical and equitable basis for allocation, it is contemplated that these amounts will be credited to the patrons' capital credit accounts. For example, gains on sales of property would be included in the amounts to be allocated. Contributions in aid of construction, forfeited membership fees, and gains on acquired capital credits would not be included.

Since most cooperatives have not been allocating non-operating margins to patrons, and past operating deficits have not been offset, any accumulated non-operating margins should be applied against any accumulated deficits. This would not affect the cash position or change the total net worth of the cooperative. If a balance of non-operating margins remains after this offset, the board should decide whether such balance should be allocated to patrons retroactively or remain unallocated. The amount of the balance involved and administrative costs are among the factors to be considered in making this decision.

Cooperatives sometimes engage in minor merchandising activities as a part of power use programs. Any losses from merchandising are borne by the patrons from the cooperative's total operations. Margins resulting from such merchandising activities should generally be included with other so-called non-operating margins to be assigned on a patronage basis. Except where a borrower engages in substantial merchandising activities, and accounts for them separately, there is no need for a specific bylaw provision relating to "Patronage Refunds in Connection with Furnishing Other Services" (Section 3 of the Non-Profit Operation article of the bylaws.)

Allocation of Credits to Patrons' Capital Accounts: The bulletin (Paragraph III A 1 and 2) recommends that the amounts to be credited to the capital account of each patron be determined on a patronage basis. The term "patron" means both member and non-member. No patron should be asked by contract or otherwise to waive his capital credits.

While operating and non-operating amounts are discussed separately in this Appendix, it should be recognized that, as a practical matter, all amounts -- regardless of source -- to be allocated to patrons would be added together and only one allocation would be made annually to each patron. The cooperative, however, should maintain separate records of the annual operating and non-operating margins.

The calculation of credits should be based on the total dollar volume of business done with the cooperative, or on a fair and reasonable variation of this method where it will be more equitable to the consumers. For example, some electric cooperatives provide for deducting from each consumer's annual power bill the direct cost of the kwh purchased by him, and for allocating the capital and other allocable amounts among the consumers on the basis of, and only in proportion to, the remaining balance of the payments for power. Such a method is simply one approach - and, seemingly, a fair and equitable approach -

to the problem of allocating to each consumer his proportionate part of one of the items of cost before arriving at the balance available for capital credits. This and any other method which seeks to break down any of the elements of cost on an equitable and reasonably determinable basis would appear to be proper.

Where service is being rendered to various groups of consumers (such as industrials and commercials) under different rate structures and possibly under different cost of service conditions, it may be appropriate in some cases, that in the determination of the amounts of capital, if any, furnished by such consumers, different approaches or factors be used for these different groups of consumers. To conform to the principle of non-profit operation, such determinations must be reasonably supportable by differences in the cost of service to and the rates paid by such consumers and be reasonably designed to ascertain as accurately as possible the amounts paid by the consumers in excess of the cost of service to those consumers.

Generation and Transmission Cooperatives: Generally, the handling of capital credits for either type of electric cooperative - G&T or distribution - would be the same. Capital credited to the account of a distribution cooperative by a G&T cooperative is an investment by the distribution cooperative in the capital of the G&T cooperative. This capital investment is made initially as a part of the payment for power purchased. While this payment is not broken down for reporting purposes by the distribution cooperative, the capital portion of the payment is, in effect, a reduction in the cost of power which would increase the amount available as capital credits to the distribution cooperative's consumers. The distribution cooperative should allocate to its patrons the capital credits assigned to it by the G&T cooperative at the same time it allocates other capital. In this way, allocation and retirement of capital credits arising from G&T operations will be treated by the distribution cooperative in the same manner and as part of any other capital credits allocated to its patrons.

Estates of Deceased Patrons: Capital credits of deceased patrons may be retired to facilitate the settlement of estates. Under the bylaws, settlements of this type are discretionary with the board so long as they are made under a policy of general application. Some boards have applied a discount because the retirements are made out of turn although many boards have found it more desirable to make such retirements on a 100 percent basis. The financial condition of the cooperative and the expected number of requests of this nature over the years are important factors to consider in establishing a general policy. REA Bulletins 102-2 and 402-2 waive the mortgage provision requiring certain amounts and kinds of assets as a prerequisite to retirements of capital credits of deceased patrons under specified conditions.

Patrons Who Discontinue Service: REA recommends that patrons who discontinue service should not be given a preference on capital credit retirements over other patrons who continue to take service, either by way of immediate cash refunds or by applying capital credits against unpaid bills. Such a patron is not entitled by the termination of his service to an immediate capital credit refund. His credits normally would be paid off only at the time the cooperative is making a general retirement of credits for a particular year, either by cash or by offset against any unpaid bills. In the meantime his record is held as an inactive account. If a patron cannot be located through his last known address when a general retirement is made, his capital credit record should be retained, and the cooperative can continue using the capital until it is called for by the rightful claimant. If a patron terminates his service, he may under the bylaws assign his capital credits to his successor in interest or occupancy.

Income Tax Treatment of Electric and Telephone Cooperatives: The Federal income tax law has long contained language exempting certain nonprofit organizations and cooperatives from the tax and these exemption provisions have been continued, although rewritten and modified in certain respects over the years. Section 501(c)(12) of the Internal Revenue Code of 1954* is the provision generally held applicable to electric and telephone cooperatives.

It provides exemption for:

> "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses."

Telephone cooperatives are specifically mentioned and electric cooperatives are considered "like organizations" within the meaning of this language. Under applicable income tax regulations, tax exemption is not automatic and is recognized by the Internal Revenue Service only after a cooperative has filed an application therefor with the appropriate District Director of Internal Revenue. An organization that is authorized to pay or pays dividends on its stock or membership fees as distinquished from patronage refunds or capital credits would not be eligible for exemption under Section 501(c)(12) according to the position taken by the Internal Revenue Service.

*The Revenue Act of 1962, insofar as it affects the tax treatment of cooperatives and their patrons, does not apply to either (a) electric or telephone cooperatives exempt under Section 501(c)(12), or (b) presently taxable cooperatives which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. (Sec. 1381(a)(2)(A) and (C), Internal Revenue Code of 1954, as amended by the Revenue Act of 1962) Electric and telephone cooperatives and their patrons are, of course, still governed by the previously applicable law.

Most electric and telephone cooperatives have qualified for exemption under Section 501(c)(12) and exemption, once established, would continue in effect from year to year as long as the cooperative meets the requirements for exemption under this Section.* As an exempt organization, however, annual information returns (Form 990) are required. The information return calls for a report on changes in a cooperative's articles of incorporation or bylaws, or any change in its method of operation in order that the effect, if any, of such changes upon the exempt status of the organization may be determined. Compliance with articles and bylaws upon which exemption was granted is, of course, always essential.

While as indicated above only one allocation would be made annually to each patron, care should be taken to insure that the cooperative's accounts will separately reflect the amounts of all operating and non-operating margins. Such segregation of these respective items on the cooperative's books may not be significant so long as it remains exempt from Federal income tax. However, if a cooperative does not have exempt status or has lost it after having been exempt for a period of years, only the amount of the allocations attributable to the operating margin would be deductible in computing the cooperative's taxable income.

Income Tax Status of Capital Credits to Patrons: For the patron of an electric or telephone cooperative who uses service for only non-business purposes, capital credits would in no way enter into his Federal income tax calculations. They merely have the effect of reducing the cost of the electricity or telephone service purchased for personal, living or family use. A patron of an electric or telephone cooperative who deducts all or a portion of his electric or telephone bill as a business expense may, however, have his individual Federal income tax liability affected. The cash received by such a patron, when his capital credits are retired, should normally be reported as ordinary income in the year received but only in the same proportion that payments for service had previously been deducted as business expenses. Patrons may have tax questions of an individual nature and these should be taken up by the patron with the Internal Revenue Director for his district.

Information to Patrons on Capital Credits and Notification of Capital Credited to Their Accounts: REA recommends that members and patrons be given full information concerning capital credits. This is essential to good cooperative relations with members and patrons and to their better understanding and support of the cooperative. It is equally important that members and patrons be notified promptly of the amount of capital

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*An electric cooperative in Tennessee has, as a result of a decision of the U.S. Circuit Court of Appeals in U.S. v. Pickwick Electric Membership Corporation, 158 F (2d) 272 (C.A. 6th, 1946), been held exempt under Section 101 (8) of the Internal Revenue Code of 1939 (Section 501(c)(4) of the 1954 Code) as an organization 'for the promotion of social welfare.' The Internal Revenue Service, however, does not agree with this decision. Revenue Ruling 57-494, 1957-2 C.B., 315.

credited to their accounts each year. As capital is returned to patrons, the cooperative not only should explain the payments to the patrons but also should acquaint the local community of its action and why the payments are being made. Information concerning each of these activities enables the members, patrons and the entire community to have a better understanding of the non-profit character of the cooperative and of the fact that it is locally owned and operated to provide maximum benefits to its consumers.

Recommended Capital Credit Bylaw Provisions: The attached bylaw provision entitled "Non-Profit Operation" incorporates REA recommendations set forth in Bulletin 102-1: 402-3 and discussed in the Appendix A. To effect these recommendations, the capital credit bylaw provision which many cooperatives have adopted would require amendment. The changes are indicated as follows:

1. Recommended additions are shown in italics and marked by the word "Addition" in the margin.

2. Recommended deletions are shown by a line drawn through the words to be deleted and are marked by the word "Deletion" in the margin.

In addition to this provision, other portions of a cooperative's bylaws may deal with capital credits. These other provisions also help in clearly establishing the contractual relationship between the cooperative and its members. For example, the provision obligating each member to purchase service from the cooperative, and to pay therefor monthly at rates to be determined from time to time by the board should also provide that it is expressly understood that amounts paid by members in excess of the cost of service are furnished by members as capital and each member shall be credited with the capital so furnished as provided in the bylaws. The provision in some of the older electric cooperative bylaws to the effect that "termination of membership shall operate as a release of all right, title and interest of the member in the property or assets of the cooperative" must be deleted since, under capital credits, a former member would not lose the right to any capital credited to his account while taking service merely upon termination of his membership. He may cease to be a member with voting rights but he would not forfeit his capital credits. In addition to the bylaws, there may be instances in which a cooperative's articles of incorporation include some or all of the provisions discussed above depending upon the requirements of the incorporation statute.

Cooperatives which have not yet adopted capital credits should amend their bylaws to include the attached "Non-Profit Operation" provision. The words shown in italics should, of course, be included and the words marked for "Deletion" omitted. Provisions of their bylaws dealing with the disposition of revenues and receipts should be repealed since the new language would replace these provisions and establish the basic contract between the cooperative and its members. In addition, other amendments of the bylaws may be necessary as indicated above. Appropriate revisions of articles of incorporation may also be necessary.

ARTICLE ______

"NON-PROFIT OPERATION

SECTION 1. Interest or Dividends on Capital Prohibited. The Cooperative shall at all times be operated on a cooperative non-profit basis for the mutual benefit of its patrons. No interest or dividends shall be paid or payable by the Cooperative on any capital furnished by its patrons.

SECTION 2. Patronage Capital in Connection with Furnishing Electric Energy.* In the furnishing of electric energy* the Cooperative's operations shall be so conducted that all patrons will through their patronage furnish capital for the Cooperative. In order to induce patronage and to assure that the Cooperative will operate on a non-profit basis the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy* in excess of operating costs and expenses properly chargeable against the furnishing of electric energy.* All such amounts in excess of operating costs and expenses at the moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital. The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses. The books and records of the Cooperative shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron, and the Cooperative shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account. All such amounts credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital.

Addition

All other amounts received by the Cooperative from its operations in excess of costs and expenses shall, insofar as permitted by law, be (a) used to offset any losses incurred during the current or any prior fiscal year and (b) to the extent not needed for that purpose, allocated to its patrons on a patronage basis and any amount so allocated shall be included as a part of the capital credited to the accounts of patrons, as herein provided.

In the event of dissolution or liquidation of the Cooperative, after all outstanding indebtedness of the Cooperative shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights of members. If, at any time prior to dissolution or liquidation, the board of directors shall determine that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be

*For telephone cooperatives, the words "electric energy" should be changed to read "telephone service."

Deletion

retired in full or in part. Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the Cooperative being first retired. ~~In no event, however, may any such capital be retired unless, after the proposed retirement, the capital of the Cooperative shall equal at least forty per centum (40%) of the total assets of the Cooperative.~~

Capital credited to the account of each patron shall be assignable only on the books of the Cooperative pursuant to written instructions from the assignor and only to successors in interest or successors in occupancy in all or a part of such patron's premises served by the Cooperative unless the board of directors, acting under policies of general application, shall determine otherwise.

Notwithstanding any other provision of these bylaws, the board of directors, at its discretion, shall have the power at any time upon the death of any patron, if the legal representatives of his estate shall request in writing that the capital credited to any such patron be retired prior to the time such capital would otherwise be retired under the provisions of these bylaws, to retire capital credited to any such patron immediately upon such terms and conditions as the board of directors, acting under policies of general application, and the legal representatives of such patron's estate shall agree upon; provided, however, that the financial condition of the Cooperative will not be impaired thereby.

The patrons of the Cooperative, by dealing with the Cooperative, acknowledge that the terms and provisions of the articles of incorporation and bylaws shall constitute and be a contract between the Cooperative and each patron, and both the Cooperative and the patrons are bound by such contract, as fully as though each patron had individually signed a separate instrument containing such terms and provisions. The provisions of this article of the bylaws shall be called to the attention of each patron of the Cooperative by posting in a conspicuous place in the Cooperative's office.

Deletion

~~SECTION 3. Patronage Refunds in Connection with Furnishing Other Services. In the event that the Cooperative should engage in the business of furnishing goods or services other than electric energy, all amounts received and receivable therefrom which are in excess of costs and expenses properly chargeable against the furnishing of such goods or services shall insofar as permitted by law, be prorated annually on a patronage basis and returned to those patrons from whom such amounts were obtained.~~"

umns, opposite each name, the number of the contract, the date of the filing, and a brief description of the products, goods or services covered by such contract.

(3) The recording constitutes notice to all persons of the association's rights under the contract. The recording also constitutes such notice that an interest in the title to all products agreed to be sold by the member–maker of such contract to the association during the term of such contract is vested in the association. In case of a purchase of any such product thereafter by any party other than the association from any party other than the association, no interest of any nature shall pass to such other purchaser; the association may recover the possession of such products from any person in whose possession they may be found, may obtain an injunction to prevent any attempted purchase, receipt or transfer not permitted by the contract or may enforce its rights in any manner permitted by law.

(4) The recording constitutes notice to all persons that the contract is and remains a valid contract until:

(a) It expires according to its terms; or

(b) It is canceled by written mutual agreement of the parties thereto; or

(c) It is annulled or otherwise terminated by final judgment of a court.

(5) Whenever the contract has been terminated in any such manner, the association shall give, upon demand, a statement of termination to the member–maker of the contract. Such member may record such statement in the office of the register of deeds where the contract was originally filed or recorded. At least once each year the association shall record in the office of the register of deeds where the contract was originally filed or recorded, a sworn list of the names of all member–makers whose contract has been terminated in any manner specified by sub. (4) (b) and (c). For any recording under this subsection the register of deeds shall receive the fee specified under s. 59.43 (2) (ag).

History: 1981 c. 245; 1985 a. 30 s. 42; 1993 a. 301; 1995 a. 201, 225.

185.43 Relief against breach or threatened breach. **(1)** In the event of a breach or threatened breach of a contract authorized by s. 185.41 by a member, the association shall be entitled to an injunction to prevent the breach or any further breach thereof, and to a decree of specific performance. Upon filing of a verified complaint showing such breach or threatened breach, and upon filing a sufficient bond, the association shall be entitled to a temporary restraining order against the member.

(2) Any person, with actual or constructive notice that a contract exists, who induces or attempts to induce any member to breach or repudiate the member's contract with the association, or who in any manner aids a breach of such contract, is liable to the aggrieved party for damages caused by such interference. The association is also entitled to an injunction to prevent any interference or further interference with the contract.

History: 1993 a. 482.

It is not necessary to have demonstrated intent to induce a cooperative member to breach or repudiate his contract with his association, because injury is presumed from violation of the statute. Pure Milk Products Coop. v. NFO, 64 Wis. 2d 241, 219 N.W.2d 564.

185.44 Application of ss. 185.41 to 185.43; venue of action. **(1)** Sections 185.41 to 185.43 apply after July 13, 1955 to all contracts whether made before or after that date.

(2) The proper place of trial of any action by or against an association when based on ss. 185.41 to 185.43 is in the county where the association has its principal office or registered agent.

185.45 Apportionment and distribution of proceeds. At least once annually the directors shall determine and distribute net proceeds as follows:

(1) There shall be deducted from total proceeds:

(a) All operating expenses and costs.

(b) The cost of supplies, commodities, equipment and other property or services procured or sold for patrons.

(c) The cost of services performed for patrons.

(d) All taxes and all other expenses.

(e) Reasonable and necessary reserves for depreciation, depletion and obsolescence of physical property, doubtful accounts and other valuation reserves, all of which shall be established in accordance with usual and customary accounting practices.

(2) The remainder of the total proceeds are net proceeds and shall be distributed and paid as follows:

(a) An amount not to exceed 5 per cent thereof may be set aside as an educational fund to be used in teaching or promoting cooperative organization or principles. Such funds shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperative.

(b) A share of the net proceeds may be set aside for or paid to officers or employees, or both. Such amount shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperative.

(c) In a cooperative organized with capital stock such dividend may be paid upon capital stock as is authorized by the articles. No dividend may be paid if the capital is impaired or if payment of such dividend would result in an impairment of capital.

(3) Unless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not, as follows:

(a) Reasonable reserves for necessary purposes may be created, which shall be credited to patrons in accordance with the ratio which their patronage bears to total patronage.

(b) All the remainder of the net proceeds shall be distributed and paid to patrons in accordance with the ratio which their patronage bears to total patronage.

(c) There shall be no distinction between the persons entitled thereto, but such reserves and distributions may be based upon business done with particular departments or in particular commodities, supplies or services, or upon classification of business according to the type or nature thereof.

(4) If the articles or bylaws so provide:

(a) Any of the net proceeds may be credited to allocated or unallocated surplus or reserves of the cooperative.

(b) None of the remainder shall constitute income to the cooperative, but all of it shall be distributed and paid in accordance with the ratio which individual patronage bears to total patronage, either to member patrons only, to member patrons only with one or more classes receiving a lower proportion than others or to all patrons with nonmembers receiving a lower proportion than members, as the bylaws provide. There shall be no other distinction between members and nonmembers, but distribution may be based on business done with particular departments, or in particular commodities, supplies or services, or upon classification of business according to type or nature.

(5) The distribution and payment of net proceeds under sub. (3) or (4) may be in cash, credits, stock, certificates of interest, revolving fund certificates, letters of advice, or other certificates or securities of the cooperative or of other associations, limited liability companies or corporations, in other property, or in any combination thereof.

(6) All or any part of the net proceeds may be applied to losses incurred in prior years, and the bylaws may also include any reasonable provisions for the apportionment of losses.

History: 1985 a. 30 ss. 23, 42; 1993 a. 112.

In action to enforce security interest in certificates of deposit, in absence of article or bylaw provision crediting net proceeds to surplus or reserves, proceeds from cooperative business in excess of actual expenses and compensation of employees belongs to patrons, not cooperative. Barron 1st Nat. Bk. v. Barron Co. Coop. DCBSA, 77 Wis. 2d 1, 252 N.W.2d 57.

TAX MANAGEMENT

Taxation of Cooperatives

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This Portfolio revises and supersedes 229-2nd T.M., *Taxation of Cooperatives.* Portfolio 229-2nd T.M. should be discarded.

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DETAILED ANALYSIS

I. Introduction

A. *The Cooperative Concept*

A cooperative is a business entity of a unique form that distributes its income to a particular member in accordance with that member's use of the cooperative. This feature distinguishes a cooperative from the partnership or corporate form of doing business.[1] The primary function of a cooperative is the allocation of economic benefits, either in the form of net savings or net earnings, to the member-patron based on the quantity of business done with the member-patron. For other entity forms, such as corporations or partnerships, economic benefits are allocated based on the amount of investment in or services provided to the organization. Cooperatives, however, resemble other businesses in certain respects. Cooperatives have similar physical facilities, perform similar functions, and must follow sound business practices. Cooperatives usually incorporate under state laws, although state statutes are specifically designed for cooperatives. Cooperatives draw up bylaws and other documents. Members elect a board of directors. Despite these similarities, cooperatives remain different from other businesses with respect to their purpose, ownership, control and distribution of benefits.

Most cooperatives are characterized by democratic ownership and user control, limited returns to capital, return of net income or margins to users on the basis of use, and the obligation of users to provide equity or ownership financing. Democratic control generally means that a member has one vote regardless of the amount of that member's patronage or stock investment. Some states, however, permit voting based upon a member's patronage and stock investment. In those jurisdictions, the power of a single member is usually limited by allowing the member to cast no more than a small percentage of total qualified votes, typically less than three percent.[2]

Most states have statutory limits specifying the maximum rate of return on investment capital. In many jurisdictions, an eight percent rate is established as the maximum return, but some states establish much higher limits. These statutes are premised upon the general idea that an agricultural cooperative is not designed as a for-profit investment vehicle.

The feature that cooperative profits are distributed in accordance with a particular member's use (also known as patronage) is consistent with the goal of maximizing members' interests and the notion that the cooperative is an extension of the members' business operations. To accomplish this objective, a cooperative attempts to market patrons' commodities at the highest possible price and purchase quality inputs at the lowest possible cost. The resulting savings (usually referred to as net income rather than profits) belong to the patrons and are distributed to them at least annually, usually in the form of patronage refunds, though not necessarily all in cash. Typically, at least 20% is paid out as a cash patronage refund and the balance is invested in the user's name as a retained patronage refund. The retained portion is redeemed at a later time, usually when the user has stopped using the cooperative.

Generally, but not always, cooperatives are formed under state "cooperative" statutes.[3] An organization may be "operating on a cooperative basis"[4] for federal tax purposes even though it is organized under a state business corporation or trade association statute.[5] The Internal Revenue Code ("Code") does not define "operating on a cooperative basis;" however, administrative and judicial

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[1] While a primary objective of cooperative formation is to provide members with a measure of economic market power, rarely will the business a single cooperative member transacts have a perceptible impact on prices paid for inputs or on prices received upon sale of products produced. Consequently, a cooperative is designed to give its members the benefits of group action in the production and marketing of commodities, and in obtaining supplies and services.

[2] In some states, the percentage is higher. For example, in Kansas the limit is five percent. *See* Kan. Stat. Ann. §17-1613 (1996).

[3] See, *e.g.*, N.Y. Coop. Corp. Law §110 *et seq.*; Minn. Stat. §308.05 *et seq.*; D.C. Code §29-801 *et seq.*; Tex. Agric. Code §51.001 *et seq.*; Wis. Stat. §185.01 *et seq.*, Cal. Agric. Code §54001 *et seq.*

[4] §1381. All references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated. Regulations defining "operating on a cooperative basis" were prepared in draft form in 1974. However, their provisions encompassed such sensitive areas as one person-one vote, netting, and the application of §277 to cooperatives, that they were never released, even as proposed regulations. *See* 27 *Coop. Accountant* 37 (Spring 1974). In PLR 8937019, the IRS, citing ***Puget Sound Plywood, Inc. v. Comr.***, 44 T.C. 305 (1965), *acq.*, 1966-1 C.B. 3, ruled that a corporation was taxable as a cooperative since it adhered to the three basic principles of cooperatives: (1) no dividends paid on capital contributions; (2) patronage distributions based on business done with or for the cooperative; and (3) democratic control. *See also* PLR 9402012 (survivor of merger of affiliated laundry service and purchasing service for group of hospitals taxed as cooperative because it operated on a cooperative basis under §1381(a)(2)); PLR 9322028 (corporation providing storage and loading services deemed to be operating on a cooperative basis after amending its by-laws to call for subordination of capital, democratic control, and operation at cost); PLR 9313016 (purchasing corporation with democratic control, subordination of capital, and allocation of excess operating revenues considered to be operating on cooperative basis under §1381(a)(2)); PLR 9237013 (changes in base capital plan did not cause wholesale supply cooperative to cease operating on cooperative basis); PLR 9235011 (taxable parent corporation's transfer of business assets to subsidiary in split-off permitted parent to qualify for taxation as purchasing cooperative).

[5] An organization operating on a cooperative basis may deduct patronage allocations even though it is organized under a state's business corporation statute. *See* ***Smith & Wiggins Gin, Inc. v. Comr.***, 37 T.C. 861 (1962), *aff'd*, 341 F.2d 341 (5th Cir. 1965); ***U.S. v. Mississippi Chemical Co.***, 197 F. Supp. 490 (S.D. Miss. 1961), *aff'd*, 326 F.2d 569 (5th Cir. 1964); ***Linnton Plywood Ass'n v. U.S.***, 410 F. Supp. 1100 (D. Or. 1976); ***Producers Gin Ass'n, A.A.L. v. Comr.***, 33 T.C. 608 (1959), *acq.*, 1960-2 C.B. 6; ***Southwest Hardware Co. v. Comr.***, 24 T.C. 75 (1955), *acq.*, 1955-2 C.B. 9; ***United Cooperatives, Inc. v. Comr.***, 4 T.C. 93 (1944), *acq.*, 1945 C.B. 6; ***Peoples Gin Co., Inc. v. Comr.***, 41 B.T.A. 343 (1940), *aff'd*, 118 F.2d 72 (5th Cir. 1941); ***Eugene Fruit Growers Ass'n v. Comr.***, 37 B.T.A. 993 (1938).

interpretations of that phrase are discussed later in this Portfolio.[6]

The two principal criteria for "operating on a cooperative basis" are patron ownership of the entity and patronage dividends.

1. Patronage Ownership

Ownership of the cooperative is vested in the persons who patronize the cooperative, rather than in investor-stockholders. This does not mean that all patrons must have an ownership interest. Many cooperatives do significant amounts of business with persons or entities which do not have an ownership interest (sometimes referred to as "nonmember business" or "nonmember patronage").[7]

2. Patronage Dividends

Cooperatives return their earnings only to their patrons (or to their member-patrons), in proportion to their patronage.

While pronouncements have been made by the IRS asserting other criteria for "operating on a cooperative basis," patronage ownership and patronage dividends are central to much litigation and administrative rulings.[8] Other criteria are discussed later in this Portfolio.[9]

B. Scope of Coverage of Portfolio

This Portfolio examines the application of federal income tax law to cooperatives. The primary Code provisions are §521 (for exempt cooperatives) and §§1381-1388 (Subchapter T). Certain cooperatives or similar entities are specifically excluded by §1381(a)(2)(B) and (C) from the provisions of these sections and are excluded from the coverage of this portfolio. These include cooperative housing corporations,[10] rural electric associations and telephone cooperatives,[11] mutual savings banks,[12] and mutual insurance companies.[13] This Portfolio does not examine state taxation of cooperative associations.[14]

C. Cooperative Tax Principles

Cooperatives calculate taxable income and use tax rates just as other corporations do, but with one principal difference related to a cooperative's distinct way of distributing net margins (profits) to its patrons based on use rather than to investors based on investment.

In general, earnings of a cooperative flow through the cooperative to patrons, with the cooperative not retaining any margins as profit. Thus, earnings are taxed only once. The tax is ultimately paid by the cooperative patron, although under some circumstances, the cooperative pays tax on a temporary basis, then receives a deduction when the money is finally passed on to the patron. The rule of single taxation, however, only applies if business income sources and distribution methods are "cooperative" in nature. Earnings derived from nonpatronage sources and margins not distributed in the manner specified by the Code are generally ineligible for single-level tax treatment.

Upon the satisfaction of certain statutory conditions, cooperatives treat retained patronage refunds and per-unit retains as if the funds retained had been paid to the patron, deducted by the cooperative, accounted for in the patron's income as ordinary income, then invested in the cooperative. Conditions for this tax treatment include agreement by the patrons to recognize the full patronage refund for tax purposes even though not received in cash or negotiable form.

Farmer cooperatives that meet several organizational and operational rules set forth in §521 are allowed to deduct two additional items: (1) dividends paid on capital stock and (2) distributions of nonpatronage earnings to patrons on the basis of their patronage.[15]

1. Tax Treatment of Cooperatives Before 1962

While farmer cooperatives existed before the federal income tax, the Revenue Act of 1913 did not mention cooperatives. Tax exemptions for marketing cooperatives (1916)[16] and purchasing cooperatives (1921)[17] were enacted for cooperatives which dealt only with members. By 1926, Congress added requirements limiting dividends for capital stock and restricted reserves of an exempt cooperative.[18] In 1934, Congress allowed business with the United States to be disregarded for purposes of determining whether a cooperative would meet the standards for exemption from federal income tax.[19]

Until 1951, farmers' cooperatives which met the exemption rules did not pay tax. In 1951, former §522 was enacted giving "exempt" cooperatives the right to claim certain deductions for dividends on capital stock and patronage distributions from income from sources other than patronage.[20] While still termed "exempt," cooperatives were subject to the corporate tax. A cooperative which distributed patronage dividends could deduct them in determining taxable income and the patron would pay the tax on dividends received. A series of court decisions in the mid-1950's, upset the general tax scheme of the Revenue Act of 1951, however. Courts held that patronage refunds "paid in paper" (termed written notices of allocation) had no value and were not taxable income to their recipients.[21] While the cooperative could still deduct the allocation, no tax was being paid at either the cooperative or the patron

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[6] See I, C, 2, b, below.

[7] The word "member" has different meanings in different cooperatives. Some cooperatives have no capital stock, and therefore have "members" who may or may not hold "membership certificates." Other cooperatives issue common stock (and also may issue preferred stock), and refer to their shareholders either as "stockholders" or as "members."

[8] A subsidiary that deals only with its parent (the "patron") is not acting for the mutual benefit of its members and cannot be a cooperative. PLR 8225013 (cooperative cannot have only one patron).

[9] See I, C, 2, b, below.

[10] §216. See 596 T.M., *Cooperative and Condominium Apartments.*

[11] §501(c)(12).

[12] §591.

[13] §501(c)(15).

[14] Caveat: The reader is cautioned to study carefully the consequences under state law of any proposed transaction.

[15] §§521(b), 1381(a)(1); 1382(c). See II below.

[16] Revenue Act of 1916, §11(11).

[17] Revenue Act of 1921, §11(11).

[18] Revenue Act of 1926, §231(12).

[19] Revenue Act of 1934, §101(12).

[20] Revenue Act of 1951, §314.

[21] *See, e.g., Long Poultry Farms, Inc. v. Comr.*, 27 T.C. 985 (1957), *rev'd*, 249 F.2d 726 (4th Cir. 1957); *Carpenter v. Comr.*, 20 T.C. 603 (1953), *aff'd*, 219 F.2d 635 (5th Cir. 1955), *acq.*, 1958-2 C.B. 4; *Caswell's Est. v. Comr.*, 211 F.2d 693 (9th Cir. 1954), *rev'g* 17 T.C. 1190 (1952).

level. This led to the enactment of Subchapter T (§§1381-1388) and repeal of §522 in 1962. The purpose was to impose a single tax on all earnings of a cooperative, either at the entity or member level.[22]

2. *The Statutory Scheme*

a. *In General*

Subchapter T of the Code, "cooperatives and their patrons,"[23] is the basis for cooperative taxation and the taxation of patrons.

Part I of Subchapter T consists of three sections. Section 1381 describes cooperative organizations to which Subchapter T applies. Subchapter T applies to all farmer cooperatives, including farmer cooperatives qualifying under §521.[24] However, a business need not be a farmer cooperative to qualify for Subchapter T tax status. Any business "operating on a cooperative basis" uses Subchapter T when computing its tax liability.[25] Section 1382 describes how cooperatives calculate their taxable income. This provision explains how cooperatives may reduce their gross income by the amount they pay in noncash patronage refunds and per-unit retains. Section 1382 also covers the time period in which patronage and per-unit retains must be paid, special accounting rules for pooling arrangements, and the problem of earnings received after patronage has occurred. Section 1383 describes how a cooperative is to compute taxes in the year it redeems nonqualified written notices of allocation and nonqualified per-unit capital retains. The cooperative makes two alternative calculations described in the section and uses the more favorable of the two.

Part II of Subchapter T consists only of §1385. This section addresses patron taxation. It describes how patrons are to account for patronage refunds and per-unit retains received from a cooperative. Under §1385, patrons are to exclude from gross income patronage refunds properly taken into account as an adjustment in the basis of property, or attributable to personal, living or family items.

Part III of Subchapter T consists of §1388. This section contains an important set of definitions including such key cooperative tax terms as "patronage dividend (refund)," "written notices of allocation," "qualified written notice of allocation," "per-unit retain allocation," and "qualified per-unit retains certificate." Section 1388 also provides rules for obtaining consent from patrons to include noncash allocations in taxable income and for the netting of patronage gains and losses.

Comment: The basic scheme of Subchapter T is deceptively simple, but variations in practices of cooperatives and concepts of the IRS result in a complex, uncertain, and often confusing body of published and private rulings.

[22] *See* H.R. Rep. No. 1447, 87th Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 113, 310 (1962).

[23] §§1381-1388.

[24] §1381(a).

[25] §1381(a)(2). Language in §1381(a)(2) specifically excludes mutual savings banks, insurance companies, and utility cooperatives from the scope of Subchapter T.

b. *"Operating on a Cooperative Basis"*

(1) *Generally*

Any corporation operating on a cooperative basis[26] may deduct from gross income (in addition to other allowable deductions) all qualified[27] patronage dividends[28] and per-unit retain allocations.[29] Moreover, it may deduct amounts paid in redemption[30] of the portions of those items which were previously distributed as nonqualified[31] written notices of allocation, or as nonqualified per-unit retains.

The fact that the Code provides that "any corporation" can be a cooperative indicates a Congressional intent to accommodate within the scope of Subchapter T the special nuances, regulatory requirements, financial arrangements, and other factors unique to various industries.

The only statutory limits to the benefit of qualifying as a cooperative are found in the definitions of a "patronage refund"[32] and "per-unit retain allocation."[33] To be excluded from taxable income, a patronage refund must be paid on the basis of the business each patron conducted with the cooperative, under a pre-existing legal obligation to make the payment, and out of earnings of the cooperative from business with patrons. In addition, refunds must be computed on the same basis for patrons who engaged in substantially identical transactions with the cooperative. Section 1388(f) requires a per-unit retain also to be made pursuant to an agreement between the cooperative and the patron.

In the late 1950s and the early 1960s, the IRS took the position that workers' cooperative associations were not among the classes of cooperatives eligible to exclude patronage refunds from taxable income.[34] In 1964, a federal district court held that a workers' cooperative was entitled to exclude retained patronage refunds from gross income to the same extent as purchasing or marketing cooperatives.[35] In 1965, the Tax Court also ruled against the IRS by holding that a workers' cooperative was a "cooperative association" for federal income tax purposes.[36] The Tax Court listed "three guiding principles" as the core of cooperative economic theory: (1) subordination of capital, (2) democratic control by the members, and (3) proportional allocation of margins on the basis of patronage.[37].

[26] §1381.

[27] §1388.

[28] §1382(b). The following statement on deducting patronage dividends appears in *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201, 213 (N.D. Iowa 1949):

> "The exclusion of patronage dividends for federal income tax purposes has not been placed upon the ground that cooperatives are special creatures of statute under the tax laws, but is justified rather upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales, allocated or distributed pursuant to a pre-existing obligation of the cooperative, and thus do not constitute taxable income to the cooperative."

[29] §1382(b).

[30] §1388.

[31] §1383.

[32] §1388(a).

[33] §1388(f).

[34] The IRS issued a revenue ruling in 1961 expressing its position on this issue. *See* Rev. Rul. 61-47, 1961-1 C.B. 193, *rev'd by* Rev. Rul. 71-439, 1971-2 C.B. 321.

[35] *Linnton Plywood Ass'n v. U.S.*, 236 F. Supp. 227 (D. Or. 1964).

[36] *Puget Sound Plywood, Inc. v. Comr.*, 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

[37] *Id.* at 308.

In 1982, the IRS issued several technical advice memoranda and private letter rulings [38] concerning the issue of whether a cooperative was "operating on a cooperative basis" by evaluating clients on the basis of the list of cooperative principles referred to in the Tax Court's 1965 *Puget Sound* decision.[39]

Beginning in 1991, the IRS, through additional rulings, added four "additional factors" in determining whether a taxpayer qualified as a cooperative: (i) existence of some joint effort on behalf of the members; (ii) a minimum number of patrons; (iii) member business exceeding nonmember business; and (iv) upon liquidation, present and former patrons sharing in the distribution of any remaining assets in proportion to the business each transacted with the cooperative over some reasonable period of years.[40] In 1993, the IRS issued a revenue ruling relying on the *Puget Sound* decision, stating that "the cooperative principles stated in *Puget Sound* . . . provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of Subchapter T of the Code." [41]

In *Puget Sound*,[42] the Tax Court clearly stated that a cooperative association with certain attributes comes within the scope of "operating on a cooperative basis" under Subchapter T. The IRS appears to be reading that decision to say only cooperatives with those specific traits *and* certain additional features can be considered as "operating on a cooperative basis." Thus, the IRS' view is that even a cooperative that meets the *Puget Sound* tests still may not be "operating on a cooperative basis" if it does not conform to various additional procedures. However, the Code's only requirement for a single tax treatment of patronage refunds is that the return or allocation of per-unit retains to patrons be on the basis of patronage pursuant to a pre-existing legal obligation.[43] Indeed, in *C.F. Industries v. Comr.*,[44] the court bolstered the view that the obligation to pay patronage refunds is the predominant characteristic of a cooperative. The court stated that the principal difference between the cooperative form of doing business and the corporate form is that the shareholders of a cooperative share in the cooperative's income in proportion to their purchases from the cooperative rather than based upon the number of shares they own.[45]

Comment: The holding in *C.F. Industries* suggests that the IRS' various expressions of cooperative principles and practices should not be read into the Code as additional mandatory restraints on organizations wishing to qualify for Subchapter T tax treatment.

The Tax Court supported this approach in *Ford-Iroquois FS, Inc. v. Comr.*,[46] where it stated that "the definition is of value as a matter of clarification but should not be used for substantive exclusion or for limitation or analysis." [47] Similarly, the Tax Court stated that "the operation at cost principle describes a feature of a cooperative's relation with its members, not a codified requirement of tax accounting." [48] In this case, the IRS was arguing that the general cooperative principle that cooperatives "operate at cost" prevented a cooperative from carrying a loss forward for tax purposes. The Tax Court rejected the IRS' position and permitted the cooperative to carry the losses forward under §172.[49]

(2) Percentage of Member Business Required

The IRS has attempted to place a quantitative requirement into "operating on a cooperative basis." In 1968, the IRS issued a ruling which implied that a cooperative might conduct less than 50% of its business with members.[50] The ruling included an example of a cooperative that conducted 50% of its business with members and 50% with nonmembers. However, in 1972, the IRS distinguished its 1968 ruling by stating that the example used in the 1968 ruling was not intended to state a rule with respect to the amount of nonmember business a "nonexempt" cooperative may have.[51] As a result, Rev. Rul. 72-602 [52] modified Rev. Rul. 68-728 [53] to the extent the former implied that a "nonexempt" cooperative which deals with nonmembers at a "profit" could conduct 50% or less of its business with members and still qualify under Subchapter T. However, three different federal courts have rejected the "percentage" rule as a requirement for "operating on a cooperative basis." [54]

In 1985, the Service ruled that, for purposes of the 50% test, a cooperative filing a consolidated corporate return with subsidiaries cannot aggregate the amount of business done by all of the subsidiaries with members.[55] Each cooperative must still conduct 50% or more of its business with its own members. In 1990, the IRS held that a corporation which estimated that less than 50% of its business would derive from members was operating on a cooperative basis.[56] Here, the corporation was found to be operating on a cooperative basis where the corporation estimated that more than 50% of the value of its business would be conducted with member and nonmember patrons, but less than 50% of the value of the business would be conducted with members.

[38] TAM 8219821; TAM 8225013; PLR 8324108; *See also* PLR 8505001 and TAM 8707005 (substituting "operation at cost" for proportional allocation of margin on basis of patronage); PLR 8744007; PLR 8748015; PLR 8823032; PLR 8842034; PLR 8850027.

[39] 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

[40] PLR 9117037; TAM 9303004. Only additional factors (ii) and (iii) were considered in PLR 9141028, PLR 9235011, and PLR 9237013. Additional factors (ii), (iii), and (iv) were mentioned in PLR 9313016. While several of the rulings state that these additional factors are considered important by the courts, no citations were provided.

[41] Rev. Rul. 93-21, 1993-1 C.B. 188.

[42] 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

[43] §1388.

[44] 995 F.2d 101 (7th Cir. 1993).

[45] *Id.*

[46] 74 T.C. 1213 (1980).

[47] *Id.* at 1217, note 3.

[48] *Id.* at 1222.

[49] *See also Associated Milk Producers, Inc. v. Comr.*, 68 T.C. 729, 740 (1977).

[50] Rev. Rul. 68-228, 1968-1 C.B. 385.

[51] Rev. Rul. 72-602, 1972-2 C.B. 510.

[52] 1972-2 C.B. 510.

[53] 1968-1 C.B. 385.

[54] *See Conway County Farmers' Ass'n v. U.S.*, 588 F.2d 592 (8th Cir. 1978), *rev'g*, 1978-1 USTC ¶9334 (E.D. Ark. 1978); *Columbus Fruit & Vegetable Coop. Ass'n v. U.S.*, 7 Cl. Ct. 561 (1985); *Geauga Landmark v. U.S.*, No. 81-942 (N.D. Ohio 1985). The Claims Court, in *Columbus Fruit*, found the IRS' position so unreasonable that legal fees were awarded to the taxpayer.

[55] PLR 8530001.

[56] PLR 9019011.

In 1991, the IRS finally conceded that a corporation may be considered to be operating on a cooperative basis even when it conducts more than 50% in value of its business with nonmembers.[57] The IRS stated that it would instead use a facts and circumstances test to determine whether an organization is operating on a cooperative basis. Similarly, in Rev. Rul. 93-21,[58] the IRS ruled that a cooperative that operates on a nonpatronage basis with nonmembers will not be precluded from being considered as "operating on a cooperative basis" simply because it conducts less than 50% in value of its business with members on a patronage basis. However, the IRS still considers the 50% rule to be a factor in determining whether a cooperative is entitled to Subchapter T tax treatment.

Whether these precedents will lead to an eventual determination that the only consideration needed in an "operating on a cooperative basis" inquiry is whether the patronage refunds or per-unit retains meet the definitional requirements of the Code is an issue that will not likely be resolved in the near future.

(3) Conducting Business with Members

As previously noted, a major distinction between a cooperative and other corporations is that a cooperative's business is done with or for its member/shareholders. In a case in which a cement company sought to classify distributions as "patronage dividends," the court found that the payments were actually dividends paid to shareholders with whom the company did not operate on a cooperative basis.[59] The court characterized the arrangement as a "cooperative camouflage" because the shareholders were not patrons of the cooperative or users of its cement. Instead, the shareholders were investors in a company which sold cement to the general public, and received distributions in the form of dividends on corporate stock.

In Rev. Rul. 82-51,[60] a poultry cooperative sold newly hatched chicks to its member/shareholders. The chicks were raised by nonmember third parties and repurchased by the cooperative when ready for market. The IRS ruled that because the shareholders were "nonessential links to the outside and not consumers of the corporate product," the cooperative was not operating on a cooperative basis. The IRS noted that the sale of the chicks to the shareholders served no business purpose other than to establish the shareholders as members and that the shareholders did not engage in the active conduct of poultry operations.

In a private letter ruling,[61] a cooperative issued preferred patronage rights to shareholders which gave the shareholders the right to purchase commodities from the cooperative in the same proportion as each patron's stock ownership. The shareholders formed another cooperative and assigned preferred patronage rights to the cooperative which then marketed the commodities purchased from the first cooperative. The IRS ruled that the second cooperative did not operate on a cooperative basis because the shareholders of the second cooperative did not purchase or produce the commodities marketed by the cooperative.

A rural electric cooperative operating under the Rural Electrification Administration guidelines was ruled to be operating on a cooperative basis when the cooperative charged its member customers "margins" which were credited to each member's capital accounts.[62] Any excess margins collected during the year were distributed back to the members on the basis of patronage.

(4) Member Participation in Management

Just as it did concerning the limitation on percentage of business, the IRS initially sought, but later abandoned, the one-member, one-vote requirement with respect to qualifying under Subchapter T.[63] The statute and regulations do not require operation on a one-person, one-vote basis for qualification as operating on a "cooperative basis." [64]

3. Filing Requirements

A "cooperative" [65] has eight and one-half months after the close of the taxable year to file its tax return. This extended filing period is available for §521 cooperatives and other Subchapter T cooperatives with an obligation to pay patronage refunds on at least 50% of their net earnings from business conducted with or for patrons.[66] Exempt cooperatives must file their tax returns on Form 990-C. All Subchapter T cooperatives must also file annual information returns, on Forms 1096 and 1099, with the IRS, reporting payments of interest, dividends and qualified written notices of allocation (patronage refunds), and redemption of nonqualified written notices of allocation, of $10 or more a year to any one person.[67] The cooperative must also include in these annual returns the amount of qualified per-unit retain certificates issued, as well as the amounts paid in redemption of nonqualified certificates of $10 or more to any one person.[68]

A cooperative is exempt from the above reporting requirements if it is primarily engaged in retail selling of goods and services that are generally for personal, living, or family use, (*i.e.*, nonbusiness use) that would not normally be reportable as income by the recipient.[69] Application for exemption from the information reporting requirement is made through the local District Director of IRS.[70]

D. Nature and Type of Cooperatives

Cooperatives are voluntary business organizations chartered by state law which enable persons to join together for

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[57] AOD 1991-018, *acq. in result only*, *Conway County Farmers Ass'n v. U.S.*, 588 F.2d 592 (8th Cir. 1978), *rev'g* 1978-1 USTC ¶9334 (E.D. Ark. 1978).

[58] 1993-1 C.B. 188, *modifying* Rev. Rul. 72-602, 1972-2 C.B. 510.

[59] *Mississippi Valley Portland Cement Co. v. U.S.*, 408 F.2d 827 (5th Cir. 1969), *aff'g*, 280 F. Supp. 393 (S.D. Miss. 1967).

[60] 1982-1 C.B. 117.

[61] PLR 8609006.

[62] PLR 9024054.

[63] *Puget Sound Plywood, Inc. v. Comr.*, 44 T.C. 305 (1965), *acq.*, 1966-1 C.B. 3 (discusses origin of cooperative concept and appears to give much emphasis to one-member, one-vote democracy concept). *See also* Rev. Rul. 66-98, 1966-1 C.B. 200 (discussion of doing business on cooperative basis).

[64] *See* §1381; Regs. §1.1381-1.

[65] As that term is defined in §6072(d).

[66] Most business corporations only have two and one-half months after the close of the taxable year to file their tax returns. §6072(b).

[67] §6044. *See also* Regs. §§1.6042-1(a)(1), 1.6044-3. *See also* Rev. Rul. 68-236, 1968-1 C.B. 382.

[68] Regs. §1.6044-3.

[69] §6044(c).

[70] §6044; Regs. §1.6044-4.

mutual help, joint purchasing, and collective marketing for the benefit of the members.[71] Agricultural cooperatives tend to be either marketing cooperatives or supply cooperatives although some conduct both functions. A marketing cooperative is designed to assist in the marketing of its members' agricultural products. A supply cooperative is designed to secure supplies and equipment needed by the membership at the lowest possible per unit cost. Many local grain cooperatives combine the marketing and supply functions and may provide services such as grain storage and drying, fertilizer application and feed grinding and mixing. There are also service cooperatives, such as rural electric and telephone cooperatives, which provide services that might otherwise be unavailable to rural residents.

The following types of cooperatives are not defined in the Code, but frequently appear in rulings and cases:

• A "local" cooperative is a cooperative whose members are farmers or other persons in the local area served by the cooperative.

• A cooperative having a "federated" structure (often called a "regional" cooperative) is a cooperative whose members include other cooperatives. It usually serves a number of "local" cooperatives, often several hundred.[72] In these types of cooperatives, patronage refunds simply pass down through the structure. Each cooperative, however, makes its own decision as to how much income to distribute to its patrons, and is generally not obligated to pass all earnings from one level to the next level.

• An "interregional" cooperative (sometimes called a "superregional") is a cooperative whose members include federated cooperatives.

• A "marketing" cooperative either functions as a purchaser of its members' products at the prevailing market rate or as a pooling agency.[73] If the cooperative purchases its members' products, the products may then be commingled with some or all of the products offered for resale. At the end of the taxable year, any resulting net earnings are allocated to each patron on the basis of the patron's percentage of business. The patron then receives his or her share of the earnings as a patronage refund.

In a marketing cooperative, members may agree to market their products to the cooperative by the use of marketing contracts. While this practice is seldom used by grain marketing and farm supply cooperatives throughout the midwest, in other jurisdictions marketing contracts may require the members to sell all or any specified part of their production through the cooperative for a specific period of time, usually not to exceed ten years. In general, exclusive cooperative marketing contracts are valid so long as they conform to the usual requirements of contract law. Generally, the cooperative's obligations under the contract are to sell the product and return the sale price to the member, deducting expenses and other costs as specified in the agreement.

• If the cooperative functions as a "pooling agency," individual farmers or ranchers, as well as farm or ranch corporations, LLCs and partnerships, contract with the cooperative to sell their product at a prescribed price, less an amount for marketing costs based on volume. All of the production for a particular season is then "pooled" and marketed. In this situation, the cooperative does not enjoy net earnings. Participants receive all of the pooled proceeds in accordance with the marketing agreement, less amounts contributed to the capital of the cooperative on a per-unit basis. These amounts are referred to as "per-unit retains." The per-unit retains are held as capital of the cooperative and are redeemed or repurchased in the same manner as deferred patronage allocations. Pooling arrangements are characterized by a sharing of risks, expenses and revenues with payment of an average price. Marketing pools tend to be heavily utilized by milk, fruit, vegetable and nut cooperatives.

• A "bargaining" cooperative bargains collectively for its members by acting as their agent. A bargaining cooperative is similar to a marketing cooperative in that it acts as an intermediary between its members and processors. Bargaining cooperatives generally do not take physical possession of agricultural products. The actual sale of the product may be made by the member to the buyer, but on terms agreed to by the cooperative. This type of marketing cooperative is almost exclusively used by dairy farmers and vegetable producers.

• A "supply" cooperative purchases the products needed by its members, such as machinery parts, fertilizer, feed or petroleum products, at wholesale prices. Large, regional cooperatives may own and operate fertilizer manufacturing plants, feed mills, oil refineries and other production plants. These products are then sold to the members as they need them. Net earnings at the end of the accounting period are distributed to the members as patronage refunds, based upon the volume of business transacted by the member with the cooperative. Some portion of these refunds may be deferred and retained by the cooperative, to be paid to the members at a future date as an equity redemption.

Most local agricultural cooperatives perform both marketing and supply functions and are "buy-sell" organizations. In addition, most agricultural cooperatives are capital stock organizations. Many of the cooperatives that began as nonstock cooperatives, issuing member certificates to their patrons, have now converted to stock cooperative status.

While the majority of cooperatives serve agriculture, any group of individuals or businesses may operate on a cooperative basis and have the benefits of Subchapter T

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[71] See I, A, above.

[72] There are several revenue rulings and revenue procedures regarding how exempt federated cooperatives may maintain their exempt status. Because this is a specialized area, it is not dealt with in this Portfolio. A practitioner interested in exempt federated cooperatives should examine the following: Rev. Rul. 84-81, 1984-1 C.B. 135; Rev. Rul. 73-138, 1973-1 C.B. 293; Rev. Rul. 72-52, 1972-1 C.B. 165; Rev. Rul. 72-51, 1972-1 C.B. 164; Rev. Rul. 72-50, 1972-1 C.B. 163; Rev. Rul. 71-493, 1971-2 C.B. 240; Rev. Rul. 69-651, 1969-2 C.B. 135; Rev. Proc. 73-38, 1973-2 C.B. 501; Rev. Proc. 72-17, 1972-1 C.B. 739; Rev. Proc. 72-16, 1972-1 C.B. 738.

[73] Legislation has been proposed to specify that a cooperative that adds value to a farmer's product by feeding the product to animals and selling the animals remains a marketing cooperative. The legislation clarifies that the phrase "marketing the products of members and other producers" includes feeding the products of members and other producers to cattle, hogs, fish, chickens or other animals and selling the animals (or animal products) which were fed such feed products. S. 2498, 105th Cong., 2d Sess. (1998); H.R. 1469, 106th Cong., 1st Sess. (1999), amending §1388 by adding new subsection (k).

(but not of §521), *e.g.*, associations of hardware dealers, grocers, and "workers' cooperatives." [74]

E. *Terminology*

1. *Margins*

"Net margins" or "margins" are synonymous with the terms "profit," "net profit," "income," "net savings" and "net income" when referring to money a cooperative earns on business conducted on a cooperative basis. Margins generally correspond to the phrase "net earnings of the organization from business done with or for its patrons" used in the Code.[75]

2. *Income*

"Income" is sometimes used on a net basis as a synonym for "profit." "Income" may, however, also be used in a gross basis to include all revenue that flows into the cooperative from business operations. "Income" is defined broadly to include cash and checks received to pay for services rendered and products provided. Income also includes interest, rents and dividends received. Funds obtained as loans or equity investments are not considered income for tax purposes.

3. *Earnings*

The term "earnings" describes what is commonly referred to as "profit," or total income less expenses. This must be distinguished from the more limited term "margins," which are earnings from business operated on a cooperative basis. Cooperatives can, and frequently do, however, conduct some of their operations on a non-cooperative basis.

4. *Patron*

The term "patron" is not statutorily defined. The regulations, however, provide that "patron" includes any person with whom a cooperative conducts business on a *cooperative basis*, whether a member, nonmember, natural person, corporation, partnership or association.[76] Those who conduct business with a cooperative on a *noncooperative basis* ("commercial customers") include suppliers to a purchasing cooperative, grain purchasers from a marketing cooperative, and drop-in trade (for example, individuals who buy gasoline from a cooperative gas station on the highway). As indicated in Rev. Rul. 76-388, 1976-2 C.B. 180, patronage status is not attained by selling minor nonproducer items to the cooperative, and patronage dividends need not be paid to those patrons. The IRS has ruled that manufacturers doing business with a cooperative can be patrons,[77] but that in the particular case in question, the shareholders of a corporation were not genuine patrons, as they received their share of earnings based on their stock holdings.[78]

5. *Patronage Refund*

A "patronage refund" consists of net margins from business conducted with or for patrons that are allocated or distributed to patrons on a patronage basis.

> *Example:* Cherry Valley cooperative has a net margin for the year of $5,000. Sid Smith accounted for five percent of the business conducted on a cooperative basis that year. Sid will receive a patronage refund of $250 ($5,000 × .05).

A primary difference between cooperatives and other forms of business is the way earnings are distributed. In a cooperative, the margins are returned to users as patronage refunds, based on the amount of business each user conducts with the cooperative. In a noncooperative business, the earnings are returned to investors as dividends, based on the amount of investment in the company. Thus, a patron's refund is a return based on use, while a dividend is a return based on investment.[79]

II. Exempt Cooperatives

A. *Tax and Information Returns for Exempt Cooperatives*

An organization attempting to be treated as an exempt farmers' cooperative for tax purposes must file a Treasury Form 1028. Although the regulations provide that Form 1028 should be filed with the District Director for the district where the cooperative's principal place of business or principal office is located, all Form 1028 exemption applications are now handled by the Ohio Key District Office, and Form 1028 must be filed with the IRS Service Center in Covington, Kentucky.[80] The cooperative may obtain a ruling in advance of conducting its operations, but must furnish information in sufficient detail to enable the District Director to find an actual or proposed compliance with the statutory requirements.[81] Special rules and procedures have been issued relative to the qualification of federated cooperatives.[82]

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[74] *See, e.g., Astoria Plywood Corp. v. U.S.*, 79-1 USTC ¶9197 (D. Or. 1979); *Linnton Plywood Ass'n v. U.S.*, 410 F. Supp. 1100 (D. Or. 1976); *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949).

[75] §1388(a)(3). In *Illinois Grain Corporation v. Comr.*, 87 T.C. 435 (1986), the court stated that "profits" and "income" are considered somewhat dirty words in the cooperative fraternity. Consistent with the broad philosophy that cooperatives are intended to operate at cost, eliminating entrepreneurial profit and returning their net earnings to their patrons on an equitable basis, . . . cooperatives tend to eschew the words "profits" and "income," preferring instead the more delicate terms "margins" and "savings."

[76] Regs. §1.1388-1(e). The major distinction between a member and a patron is that the member has voting rights and the patron does not. Some cooperatives also have nonvoting members. These persons have allocation rights if there are shortages of oil, fertilizer, or similar items. In some states, statutory voting rights are mandated where the cooperative takes action affecting a nonvoting member's stock. *See, e.g.*, Wis. Stat. §185.52.

[77] Private letter ruling dated Jan. 23, 1970. See the Working Papers.

[78] PLR 7929008.

[79] This distinction is complicated by the Code's use of the term "patronage dividends" in referring to what is generally called "patronage refund." *See, e.g.*, §§1382(b), 1388(a). Technically, a "patronage dividend" (within the meaning of the Code) is a "patronage refund" that meets certain Code requirements, such as being paid pursuant to a pre-existing legal obligation of the cooperative to make the refund. In most instances, "patronage refunds" that do not qualify as "patronage dividends" (for tax purposes) are treated as "dividends" for tax purposes. *See, e.g., Peoples's Gin Co. v. Comr.*, 41 B.T.A. 343 (1940), *aff'd*, 118 F.2d 72 (5th Cir. 1941); *Juneau Dairies, Inc. v. Comr.*, 44 B.T.A. 759 (1941).

[80] Regs. §1.521-1(a)(3)(C). *See* Instructions to Forms 1028 and 8718 and Rev. Proc. 98-8, 1998-1 IRB 225.

[81] Rev. Proc. 80-25, 1980-1 C.B. 667 contains detailed procedures for filing an application for exemption, the standards to be considered by the District Director in making a determination, the procedure for protesting an adverse determination, and the procedures to be followed upon the proposed revocation or modification of an exemption letter.

[82] Rev. Rul. 69-751, 1969-2 C.B. 135; Rev. Proc. 73-38, 1973-1 C.B. 451; Rev. Proc. 72-16, 1972-1 C.B. 738; Rev. Proc. 72-17, 1972-1 C.B. 739.

Revenue Ruling 72-36

fice of the organization. See section 1.501(a)–1 of the regulations.

Revenue Ruling 56–65, C.B. 1956–1, 199, is clarified to the extent it may imply that plan room and publication activities of the type described in this ruling are not appropriate activities of a business league exempt under section 501(c)(6) of the Code.

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26 CFR 1.501(c)(12)–1: Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

Certain requirements that cooperative companies must meet for exemption under section 501(c)(12) of the Code are explained.

Rev. Rul. 72–36

The Internal Revenue Service has received inquiries from cooperative companies regarding certain requirements for exemption from Federal income tax under section 501(c)(12) of the Internal Revenue Code of 1954.

Section 501(c)(12) of the Code provides for exemption from Federal income tax of mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, if 85 percent or more of their income consist of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 1.501(c)(12)–1(a) of the Income Tax Regulations provides that excess funds on hand at the end of the year may be retained to meet future losses and expenses, or returned to members.

The specific questions and their answers are as follows:

Question 1.

Should the interests of members in the savings of an organization be determined in proportion to their business with the organization?

Answer:

Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.

Question 2.

Can funds be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes?

Answer:

Yes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

Question 3.

Where an organization retains funds for purposes other than meeting current losses and expenses, must the organization's records show each member's rights and interest in the funds it retains?

Answer:

Yes. To maintain its mutual or cooperative character an organization must keep such records as are necessary to determine, at any time, each member's rights and interest in the assets of the organization.

Question 4.

What is the effect on exemption of a forfeiture of a former member's rights and interest where the bylaws provide for such forfeiture upon withdrawal or termination?

Answer:

If, under the bylaws, a member's rights and interest have been forfeited, the organization has not operated on a mutual or cooperative basis and is therefore not exempt.

Question 5.

Where, upon dissolution, an organization has gains from the sale of an appreciated asset, how should these gains be distributed?

Answer:

Such gains should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

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26 CFR 1.501(c)(13)–1: Cemetery companies.

The exempt status of a cemetery company is not adversely affected if it sells monuments, markers, vaults, and flowers solely for use in the cemetery and uses the sales proceeds for maintenance of the cemetery.

Rev. Rul. 72–17

Advice has been requested whether the status of a cemetery company exempt from Federal income tax under section 501(c)(13) of the Internal Revenue Code of 1954 is adversely affected where it sells monuments, markers, vaults, and flowers in the manner described below.

The organization was formed and is operated for the purpose of providing and maintaining a cemetery. The organization sells cemetery lots, provides burial services, erects monuments, and maintains the cemetery grounds. In addition, it sells monuments, markers, vaults, and flowers solely for use in the cemetery. All profits realized from these sales are used to maintain the cemetery as a whole.

Section 501(c)(13) of the Code provides for the exemption from Federal income tax of cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not

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July 31, 2002

Ms. Lynda Dorr and
The Public Service Commission
7610 N. Whitney Way
Madison, WI 53702

Re: TELEACCTG; Docket 05-US-113
Comment on Resolving the Co-op Patronage Capital Matter for Telephone Cooperatives

Dear Ms. Dorr and Commissioners:

The telephone cooperatives urge the Commission to omit cooperative patronage capital accounting from Docket 05-US-113. We further ask the Commission to review the record quickly (if that has not yet occurred) and direct the staff to adopt two sub-accounts of 32.4550 as suggested by the cooperatives for the 2002 fiscal years.

Comments on the Process

1. The delay in resolving this matter has already impeded the business activities of the cooperatives due to regulatory uncertainty. Protracted review in the broad accounting docket, 05-US-113, would only further confuse and delay those matters.
2. Originally, the staff proposed to alter cooperatives' accounting practices by a simple letter order. No public hearing was even considered, and none is required now.
3. A full record has now been placed before the Commission for review. The ripe for Commission decision now.
4. Neither the review of this matter or the accounting compliance docket is the appropriate place to adjudicate compliance with Act 496 provisions (as one competitor has suggested.) The Commission process should not be used by others for anti-competitive purposes, or obfuscation.

On The Merits of the Cooperatives' Accounting Proposal

Creating two subaccounts of account 32.4550 has two purposes. First, **placing cooperative retained earnings in two sub-accounts will preserve the cooperatives' tax status, protect member's future patronage refunds and "retain" funds for investment** in the future of the cooperative (as the members direct). Second, the cooperatives offered their proposal in response to Mr. Albino's directive to "inform the commission of the particulars constituting alternate classification". Their proposal is based on solid legal grounds.

1. Re-classification of retained earnings (Account 4550), as additional paid-in capital (Account 4520) puts the co-ops' tax status at risk because the return of patron's retained capital is fundamental to co-operative "operation on a cooperative basis." (Rev. Rul. 72-36, Attachment 5 to June 4, 2002 letter.) There is no known precedent for the reclassification, so the IRS position is unknown. A negative decision by the IRS could have monumental consequences for the cooperatives.

The PSC staff seems riveted by a literal reading of one line in the bylaws which the telephone cooperatives have adopted: "All such amounts credited to the capital account of any patron shall have the same status ***as though*** *[or* ***as if]*** they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital." (Emphasis added.)

The meaning and application of this bylaw is fundamental to co-op operation and tax status. The provision (or substantially similar versions) is in use uniformly by telephone and electric cooperatives throughout the United States. Its meaning is complex, rooted in the Internal Revenue Code. 34 Am Jur 20175 (attached) explains the key phrases and concepts.[1] [The initialed comments below correspond to points in the attached excerpt.] Also see 18 Am Jur 2d, s.23, enclosed

a) The purpose of the bylaw is to enable deduction of the patronage "dividend" paid-out to patrons from the co-op's income.
b) "[T]he same status as though paid" recognizes that the co-op can "pay" the patronage to the member by giving written notice that the margins have accrued in the member's name (if the bylaw is in place), or by payment of money, a certificate of indebtedness, or other property.
c) The Internal Revenue Code has recognized in sec. 1388(c); Reg. s.1.1388(c) that the members consent to this method of written notice by virtue of joining a cooperative under its membership agreement.[2]
d) The "legal obligation" of the cooperative to pay patronage refunds is established in the co-op's articles or bylaws, and is statutorily required in Wisconsin, too. 185.45, Wis. Stats.

2. We believe it is beyond the PSC's authority to force a regulated firm to act in a manner that would jeopardize its chosen business structure, a structure sanctioned by federal laws, including 26 USCA 501(c)(12), 1381, et. seq.; and Chapter 185, Wis. Stats.)

[1] The section is titled "Farmer' Cooperatives" under IRC 521, but as with so many IRC provisions which apply to cooperatives, the same rules apply to 501(c)(12) cooperatives.
[2] Section 1381 (often referred to as Subchapter T) specifically does not apply to telephone and electric cooperatives, meaning the prior, pre-1962 statute still applies to them. The essential difference is that telephone and electric cooperatives must meet an income-source test in order to qualify for tax-exempt status. That issue is not relevant here. In most other respects, regulation is identical.

3. For purposes of section 196.204(1), the Commission's proposed reclassification would eliminate "retained earnings" only for cooperatives. Under that statute, retained earnings are the measure (limit) of capital available for investment outside the utility. The change, if imposed only on cooperatives, would discriminate against cooperatives as compared to all other firms covered by the statute. Competitors want to do this.

4. The present system of accounting, modified by the creation of two sub-accounts of retained earnings, will avoid all these legal and political pitfalls.

5. Finally, The PSC staff also asks why account 4520 cannot accommodate patron's capital "as though paid in"? We can only say that the change introduces serious uncertainty over tax status, and puts co-ops at a decided disadvantage, as described above. **We pose a different question: If the retained earnings account isn't suited to co-ops' patronage credits, (because of the language of the Chibardun bylaw) why does the staff believe patronage refunds fit any more appropriately as paid-in capital - given the long history and documented tax and legal basis underlies treatment as retained earnings?**

One staff opinion is that 1993 Wisconsin Act 496 did not intend to accommodate telephone co-op retained earnings, and therefore the Legislature should clarify this accounting problem. We regard this as merely an excuse for PSC inaction. As explained above, co-op and IRS law has recognized co-op-retained earnings for decades. It is no less an administrative "innovation" for the PSC to interpret co-op earnings as paid-in capital than to refine the account used through history.

Requested Action

Having provided very extensive documentation and argument supporting the cooperatives' proposal for two sub-accounts, the Cooperatives now ask for an immediate decision in directing adoption of the sub-accounts of s.4550. We believe the matter can and should be handled informally, as was the staff's original plan when Mr. Albino commenced the review on December 17, 2001. If still more time is needed, please direct the staff to complete its internal review promptly so that the cooperatives can get on with business.

Sincerely,

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Attorney for Telephone Cooperatives and
Wisconsin Federation of Cooperatives

association and who has paid full value for his certificate has no priority over other certificate holders to the association's remaining assets on dissolution.[51]

The stockholders of a cooperative marketing association are interested in the assets accumulated by such association, including claims acquired by it, and hence the association is without power to cancel any such claim.[52]

§ 23. Revolving capital fund and equity credits therein

Statutes regulating the structure of cooperative associations, and bylaws of such associations adopted pursuant thereto, frequently provide for the retention by the association of all or a portion of the operating profit of the association in order to furnish capital for the association, and in evidence of this each member of the association is credited with his proportionate part on the books of the association, and is generally issued a certificate showing such credit.[53] This plan is known as the revolving fund plan, or equity plan, and the credits are known as equity credits. These credits are in effect the capital of the cooperative, and it has been said that the plan for raising capital in this way is the most equitable means by which a cooperative can acquire its capital from its patrons.[54]

The capital secured through such an equity plan is comparable to the earned surplus of a conventional business organization.[55]

It is well settled that equity credits allocated to a patron on the books of a cooperative do not reflect an indebtedness which is presently due and payable by the cooperative to such patron. Such equity credits represent patronage dividends which the board of directors of a cooperative, acting under statutory authority, has elected to allocate to its patrons, not in cash or other medium of payment, which would immediately take such funds out of the working capital of the cooperative, but in such manner as to provide or retain capital for the cooperative and at the same time reflect the ownership interest of the patron in such retained capital. Equity credits are not an indebtedness of a cooperative which is presently due and payable to the members, but represent an interest which will be paid to them at some unspecified later date to be determined by the board of directors.[56] Therefore, equity credits cannot be used as a setoff against a member's present indebtedness to the association,[57]

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51. Re Kitsap-Mason Dairymen's Asso., 6 Wash App 926, 497 P2d 604.

52. Burley Tobacco Growers' Co-op Ass'n v Tipton, 227 Ky 297, 11 SW2d 119.

53. McCauley v Arkansas Rice Growers' Co-op. Ass'n., 171 Ark 1155, 287 SW 419; Ozona Citrus Growers' Ass'n v McLean, 122 Fla 188, 165 So 625.

Practice Aids.—Provision of articles or by-laws concerning contributions to capital. 5 Am Jur Legal Forms 2d, Cooperative Associations § 71:85.

—Forms relating to Certificates on indebtedness and capital stock. 5 Am Jur Legal Forms 2d, Cooperative Associations §§ 71:131-71:138.

54. Bowles v Inland Empire Dairy Asso. (DC Wash) 53 F Supp 210.

Practice Aids.—Revolving Fund Certificate. 5 Am Jur Legal Forms 2d, Cooperative Associations §§ 71:55, 71:56.

55. Clarke County Cooperative v Read, 243 Miss 879, 139 So 2d 639.

56. Clarke County Cooperative v Read, 243 Miss 879, 139 So 2d 639; Schmeckpeper v Panhandle Cooperative Asso., 180 Neb 352, 143 NW2d 113 (final distribution of earnings and savings may be made by payment in cash, stock, stock credits, deferred credit certificates, or certificates of participation as determined by board of directors when by-laws so provide).

Annotation: 50 ALR3d 435, 486–498 §§ 20–26 (time of distribution).

57. Howard v Eatonton Co-operative Feed Co., 226 Ga 788, 177 SE2d 658; Forrest County Cooperative Assn. v Manis (Miss) 235

¶ 20175. Cooperatives—Exemption; Patronage and Nonpatronage Distributions.

34 Am Jur 2nd

A cooperative (co-op) or mutual organization generally have the same persons as owners and customers. Co-ops generally are taxed like ordinary business corporations, but some are tax-exempt. All co-ops are entitled to deduct patronage dividends, and exempt farmers co-ops may also deduct certain nonpatronage distributions.

¶ 20176. How cooperatives (co-ops) are taxed. Although some co-ops are *classified* as exempt (¶ 20177), most, exempt and nonexempt, are taxed the same as any ordinary business corporation, at the regular corporate rates, but with a deduction for patronage dividends (see ¶ 20178).[1]

Nonexempt co-ops aren't membership organizations subject to the Code Sec. 277 limits on the aggregation of member losses with nonmember income (see ¶ 16840).[2]

¶ 20177. Classification as an exempt co-op. An exempt co-op (e.g., a farmers' co-op, see ¶ 20185) is considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.[3]

observation: Although exempt co-ops are potentially subject to income tax, they're commonly referred to as exempt co-ops due to their classification as exempt organizations.

Co-op Distributions

¶ 20178. Co-op's deduction of patronage dividends and per-unit retain allocations. Patronage dividends (¶ 20179) and per-unit retain allocations (¶ 20180) represent transient amounts the co-op doesn't take into account if it pays them out as described below. This is done by treating a patronage dividend as an item of gross income and as a corresponding deduction from gross income, and by excluding or deducting the per-unit retain allocation from the co-op's income.[4]

A

Co-ops may exclude or deduct their per-unit retain allocations to the extent the amounts are paid in money, qualified per-unit retain certificates, or other property (except nonqualified per-unit retain certificates) with respect to marketing during the tax year.[5]

To be excludible (deductible), patronage dividends or per-unit retain allocations paid in money or other property (except written notices of allocation or per-unit retain certificates) must be paid by the 15th day of the 9th month after the end of the tax year. Payment may be by qualified check (¶ 20181) paid during this period, if the check is endorsed and cashed on or before the 90th day after the end of the period.[6]

¶ 20179. Patronage dividends defined. Patronage dividends represent distributions of the co-op's net earnings among the cooperators and other patrons, according to each person's patronage or contribution to its net earnings. It's an amount paid to a patron by a co-op: (1) on the basis or quantity of business done with or for that patron; (2) under a pre-existing valid enforceable written obligation of the co-op to the patron to pay that amount; and (3) determined by reference to the co-op's net earnings from business done with or for its patrons.[7]

B

A patronage dividend may be paid in money, a certificate of indebtedness, or other property, including a qualified written notice of allocation (¶ 20181).[8]

¶ 20180. Per-unit retain allocation defined. A per-unit retain allocation is an allocation (other than by paying money or other property) by a co-op to a patron with respect to products marketed for him, if the amount is fixed without reference to the co-op's net earnings, under an agreement between the patron and the co-op.[9]

B

¶ 20181. Qualified written notice of allocation and qualified per-unit retain certificates. A qualified written notice of allocation or qualified per-unit retain allocation is treated as the equivalent of money at its stated dollar amounts.[10]

A written notice of allocation may be a capital stock or revolving fund certificate, a retain certificate, a certificate of indebtedness, a letter of advice, or any other written notice which discloses the dollar amount allocated to the patron on the co-op's books and the portion that is a patronage dividend.[11] For a written notice of allocation to qualify: (1) it must be redeemable in cash at its stated dollar amount at any time within at least 90 days from receipt (the patron must have been advised in writing, of his right of redemption); *or* (2) if the notice isn't so redeemable, the patron must have consented in writing in advance to include the stated dollar amount in his income (this consent may take the form of endorsement of a qualified check); and he must have received 20% of the distribution within that 90-day period (in cash or qualified check).[12]

C

A per-unit retain certificate is a written notice which discloses the stated dollar amount of the co-op's per-unit retain allocation to the recipient.[13] A per-unit retain certificate qualifies if the distributee has agreed to take it into account at its stated dollar amount.[14]

¶ 20182. How patronage dividends and per-unit retain allocations are taxed to patrons. Patronage dividends (¶ 20179) and per-unit retain allocations (¶ 20180) received in money are included in income by the patron in the year received. Qualified written notices of allocation and qualified per-unit retain certificates (¶ 20181) are included in income at their stated dollar

1. Code Sec. 1381(b); Reg § 1.1381-1(a); Reg § 1.1381-2(a)(1).
2. Landmark Inc v. U.S., (1992, Cl Ct) 69 AFTR 2d 92-495, 25 Cl Ct 100, 92-1 USTC ¶ 50058; Buckeye Countrymark Inc, (1994) 103 TC 547 acq 1997-18 IRB 4.
3. Code Sec. 521(a); Reg § 1.521-1(a)(1); Reg § 1.1381-2(a)(1).
4. Code Sec. 1381(a); Code Sec. 1382(b); Reg § 1.1382-1; Stevenson Co-Ply Inc, (1981) 76 TC 637.
5. Code Sec. 1382(b)(3).
6. Code Sec. 1382(d).
7. Code Sec. 1388(a); Reg § 1.1388-1(a)(1).
8. Code Sec. 1382(b); Salley Inc, James W. v. U.S., (1976, DC LA) 38 AFTR 2d 76-5076, 76-1 USTC ¶ 9443.
9. Code Sec. 1388(f); Rev Rul 68-236, 1968-1 CB 382.
10. Code Sec. 1388(c)(2).
11. Code Sec. 1388(b); Reg § 1.1388-1(b).
12. Code Sec. 1388(c); Reg § 1.1388-1(c).
13. Code Sec. 1388(g).
14. Code Sec. 1388(h).

amount when received, and other property (but not nonqualified allocations or nonqualified per-unit retain certificates) is included at its fair market value when received.[15]

But the amount of any patronage dividend isn't included in income to the extent it's properly taken into account as an adjustment to basis of property, or attributable to personal, living, or family items.[16]

Patronage dividends don't qualify for the corporate dividends-received deduction (see ¶ 4201 *et seq.*).[17]

¶ 20183. Sale, redemption or other disposition of nonqualified allocations or per-unit retain certificates. The gain on redemption, sale or other disposition by any person of a nonqualified written notice of allocation or a nonqualified per-unit retain certificate is ordinary income to the extent of the excess of the stated dollar amount over basis.[18]

But if the nonqualified written notice of allocation was paid as a patronage dividend, the gain isn't included in gross income to the extent it's properly taken into account as an adjustment to basis of property, or attributable to personal, living, or family items.[19]

Farmers' Co-ops

¶ 20184. Nonpatronage distributions deductible by exempt farmers' co-ops. An exempt farmers' co-op may deduct these nonpatronage distributions (in addition to patronage dividend and per-unit retain allocations deductions, see ¶ 20178): (1) dividends paid during the tax year on its capital stock and on any other evidence of proprietary interest in the co-op;[20] (2) amounts paid in money, qualified written notices of allocation (¶ 20181), or other property (except nonqualified written notices of allocation) to patrons on a patronage basis, out of earnings from nonpatronage sources, or from business done for the U.S. or its agencies;[21] and (3) amounts paid in money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation issued to patrons on a patronage basis with respect to earnings from nonpatronage sources, or from business done for the U.S. or its agencies.[22]

If the co-op's patrons don't present its nonqualified allocations or certificates aren't presented for payment for an unduly extended period, the co-op's tax is adjusted to avoid income distortion.[23]

¶ 20185. Which farmers' co-ops are exempt. Two kinds of farmers' co-ops are exempt co-ops: (1) marketing co-ops engaged in marketing farm products for its member farmers, fruit growers, livestock growers, dairymen, etc.;[24] and (2) purchasing co-ops engaged in buying supplies and equipment for the use of the member farmers, etc., described in (1), above, which are turned over to them at actual cost, plus necessary expenses.[25]

Farmers' co-ops file a return on Form 990-C, whether or not they are subject to regular corporate taxes.[26]

¶ 20186. Exempt farmers' co-ops may have stock and reserves. A farmer's co-op can be exempt even if it has capital stock, if: (1) the dividend rate can't exceed the greater of (a) the legal rate of interest for the state of incorporation or (b) 8% of the value of the consideration for which the stock was issued; *and* (2) substantially all the stock is owned by producers who, on a current basis,[27] market or buy through the co-op.[28]

The co-op may accumulate and maintain reserves required by state law or reasonable reserves for necessary purposes and still be exempt.[29]

¶ 20187. Farmers' co-ops must apply for exemption—Form 1028. To qualify as an exempt farmers' marketing or producing co-op, the organization must file Form 1028 as prescribed in the instructions.[30]

¶ 20200. Cooperative and Condominium Housing.

Cooperative housing corporations (co-ops) and condominiums (condo) are legal forms used for group ownership of multi-unit housing. Both forms of group ownership generally provide the same tax treatment for the owners as individual ownership.

For cooperatives generally, see ¶ 20175 *et seq.*

¶ 20201. Cooperatives (co-ops) and condominiums (condos) distinguished. A co-op is a corporation that meets the four requirements at ¶ 19428.[1]

observation: In the co-op form of group ownership, title to the entire multi-unit property is held by the co-op. The stockholders occupy their dwelling units under occupancy agreements, generally in the same form as ordinary apartment leases, calling for payment of maintenance charges as fixed by the corporation's board of directors.

observation: In the condo form of group ownership, title to the multi-unit property is held by the

15. Code Sec. 1385(a).
16. Code Sec. 1385(b).
17. Code Sec. 246(a)(1).
18. Code Sec. 1385(c)(2)(C); Reg § 1.1385-1(b)(1).
19. Code Sec. 1385(b).
20. Code Sec. 1382(c)(1); Reg § 1.1382-3(b).
21. Code Sec. 1382(c)(2)(A); Reg § 1.1382-3(c).
22. Code Sec. 1382(c)(2)(B); Reg § 1.1382-3(d).
23. Code Sec. 1383(a); Code Sec. 1383(b)(1); Reg § 1.1383-1(a); Reg § 1.1383-1(c).
24. Code Sec. 521(b)(1); Code Sec. 521(b)(4); Reg § 1.521-1(a)(1).
25. Code Sec. 521(b)(1); Code Sec. 521(b)(4); Reg § 1.521-1(b).
26. Reg § 1.6012-2(f).
27. Co-operative Grain & Supply Co v. Com., (1969, CA8) 23 AFTR 2d 69-804, 407 F2d 1158, 69-1 USTC ¶ 9247; Rev Proc 73-39, 1973-2 CB 502.
28. Code Sec. 521(b)(2).
29. Code Sec. 521(b)(3).
30. Reg § 1.521-1(e); Rev Proc 90-27, 1990-1 CB 514.
1. Code Sec. 216(b).

05-US-115

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VIA HAND DELIVERY

Lynda L. Dorr
Secretary to the Commission
Public Service Commission of Wisconsin
P.O. Box 7854
Madison, WI 53707-7854

Re: Docket 05-US-115

Dear Ms. Dorr:

Attached please find the original and 15 copies of the Comments of CenturyTel, Inc. in Docket 05-US-115, Accounting Treatment for Patronage Capital by Telecommunications Cooperatives. Please file stamp the extra copy and return it to the messenger.

Very truly yours,

Bradley D. Jackson

Enclosures

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BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Accounting Treatment for Patronage Capital by Telecommunications Cooperatives

Docket No. 05-US-115

COMMENTS OF CENTURYTEL, INC.

CenturyTel, Inc. ("CenturyTel") submits these comments regarding the appropriate accounting treatment for patronage capital by incumbent local exchange carrier telecommunications cooperatives. CenturyTel is concerned with any proposed rule changes that, as here, would create a privileged class of competitor in the telecommunications arena. Like most of the Wisconsin telephone cooperatives, CenturyTel serves predominantly rural areas.

The cooperatives have asked the Commission to adopt new accounting rules that are antithetical to the very nature of the cooperatives' corporate existence. The proposed accounting rules (i) are directly contrary to the cooperatives' bylaws, (ii) would seriously threaten the quality, reliability and cost of service to ratepayers/patrons of the cooperatives, (iii) would be inconsistent with applicable tax law and (iv) would threaten the historic regulatory compact under which cooperatives have been granted monopoly status in their service territories.

There is a real threat to cooperative ratepayers when their historically cautious and frugal non-profit utility service provider is transformed into an entirely different entity. Fair competition in Wisconsin telecommunications markets would be put at serious risk. With significant amounts of protected incumbent-provider utility revenues available to subsidize risky, competitive ventures, an uneven playing field will be created to the eventual detriment of Wisconsin telecommunications consumers.

As the Commission has previously concluded, the term "retained earnings" as it appears in Wis. Stats. § 196.204(1) does not include the patronage capital of cooperatives. To determine otherwise in this proceeding would severely weaken that statute's protections against cross-subsidization of competitive businesses by telecommunications utilities by allowing telephone cooperatives to put their ratepayer/member capital dollars at risk for competitive ventures. The filings of the telephone cooperatives and the Wisconsin Federation of Cooperatives ("WFC") raise a host of mythical fears -- from loss of tax-exemption and RUS financing to the demise of the cooperative model. Rather, the proposed accounting rules would not only tilt the playing field in the telephone cooperatives' favor, it would put them and their members at greater risk of failing to maintain the very core services for which the cooperative was formed.

These comments will discuss the cooperative bylaw provisions, the unique and privileged status of cooperatives under tax law, the proposed rules, cooperative capital structure, and the effect of the proposed rules on competition.

I. **Bylaw Provisions Regarding Patronage Capital Explicitly Prevent the Proposed Rule Changes**

The Commission reviewed the relevant language in the bylaws of the cooperatives in the Chibardun case. *See Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc. of Its Subsidiaries and of Possible Related Violations*, Docket No. 1090-TI-100 (Nov. 16, 2001) ("*Chibardun Order*"). In looking at the words of the bylaws, the Commission came to the inescapable conclusion that patronage capital is not retained earnings.

Each of the cooperatives' bylaws, as noted in the Commission's Notice of Investigation, include the same relevant provisions (emphasis added):

> In order to ensure that the Cooperative will be operated on a non-profit basis . . . all such amounts credited to the capital amount of any patron shall have the same status as though paid to the patron in cash in pursuance of a legal obligation to do so and the patron has then furnished the Cooperative corresponding amounts for capital.
>
> * * *
>
> All other amounts received by the Cooperative from non-regulated or non-operating income, ... in excess of operating costs and expenses properly chargeable against the furnishing of such services, . . . shall insofar as permitted bylaw:
>
> (1) Be reserved as unallocated retained earnings, and shall not be allocated to the Cooperative's patrons on a patronage basis as part of the capital credited to the accounts of patrons, as herein provided.
>
> (2) Be used for business purposes as determined by the Cooperative.

The Commission analyzed the relevance of these provisions at pages 20-22 and correctly concluded that patronage capital is not retained earnings. *See also Chibardun Order*, Conclusion of Law #5, p. 13. The meaning is quite clear. Patronage capital (that is, the margin or profit generated by the collection of revenues from members in excess of the actual cost of service) is not available for use at management's whim but, rather, is considered "as though paid to the patron in cash" and that the patron "has then furnished the Cooperative correspondent amounts for capital." It is distinct from the cooperatives' "retained earnings" which, consistent with the bylaw excerpts above, are generated from services to non-members.

The creation of the two proposed subaccounts for "Retained Earnings-Patronage Capital Unassigned" and "Retained Earnings-Patronage Capital Assigned" cannot be squared with this plain language of the bylaws. Where the bylaws distinguish patronage capital from retained earnings, the Commission cannot and should not collapse the two. The Commission got it right in the *Chibardun Order* and the cooperatives have not presented any persuasive reason to depart from that precedent.

With all due respect, the cooperatives appear to be recommending changes that would not be appropriate in the post-Enron, post-Worldcom world of accounting. In filings to date they claim that they cannot change their bylaws because the relevant provisions are a critical part of establishing their qualifications to be a cooperative. *See also Lambert v. Fisherman's Dock Co-operative, Inc.* 297 A2d 566 (NJ 1972) (cooperatives have only limited rights to change bylaws, particularly where it affects payments due to members at termination). As they cannot freely change the bylaws, the cooperatives plead with the Commission to ignore the bylaws' explicit distinction between patronage capital and retained earnings. Now is not the time to legitimize such questionable accounting.

II. Accounting and Tax Issues

A. Patronage Capital is not Retained Earnings

Patronage capital, as the title indicates, is simply not retained earnings. To create two new accounts as proposed will not make it so. The following statement by the former Rural Electrification Administration is equally applicable to telephone cooperatives:

> In the furnishing of electric energy the Cooperative's operations shall be so conducted that all patrons will through their patronage furnish capital for the Cooperative. In order to induce patronage and to assure that the Cooperative will operate on a nonprofit basis the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy in excess of operating costs and expenses properly chargeable against the furnishing of electric energy. All such amounts in excess of operating costs and expenses at the moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital. The Cooperative is obligated to pay by credits to a capital

account for each patron all such amounts in excess of operating costs and expenses.[1]

The contrast between retained earnings and patronage capital is very clear from this announcement. In Wisconsin, this model is mandated by Wis. Stats. § 185.45.[2] Patronage capital must be returned to the members on a regular basis, upon death, upon cessation of membership and upon dissolution. This is one of the hallmarks of "operating as a cooperative" so stressed by the telephone cooperatives and the Federation.

Retained earnings,[3] on the other hand, represents the accumulated amount of after-tax net income that is available for distribution as dividends to shareholders. Shareholders have no legal right to a pro rata portion of retained earnings. The retained earnings run with the shares not the shareholder. For example, upon the death of a shareholder, there is no right to receive a portion of retained earnings. Unlike patronage capital, there is no legal requirement to pay out or allocate retained earnings on a systematic basis. Indeed, most corporations invest the retained earnings back into the business and can choose to pay out little or nothing as dividends.

Further, patronage capital must be paid out or allocated based upon patronage. Retained earnings are paid out as dividends based upon percentage ownership. This is an important distinction. Patronage capital represents the overcharge to patrons from rates exceeding actual costs. Patronage capital must be returned to patrons consistent with the

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[1] Rural electrification Administration, "Capital Credits-Consumer Benefits", Bulletin 102-1 at p. 9 (1978). Generally, see Hahne et. al., Accounting For Public Utilities, § 14.02[3], Mathew Bender (2001) (emphasis supplied).

[2] This section was adopted in 1955. The drafter's notes indicate that subsection (3) was intended for tax-exempt cooperatives and subsection (4) for other cooperatives. Both subsections are consistent with the cooperative theory that margin must be paid on a patronage basis.

[3] A common definition of "retained earnings" is: "Retained Earnings represent the undistributed earnings of an entity. Changes in retained earnings generally are limited to (a) net income or loss; (b) distributions of earnings (dividends), and (c) adjustments to the opening balances as a result of prior period adjustments or certain changes in accounting principle". Lindsey & Ruttedge, Guide to GAAP, Practitioners Publishing Company (2001).

nonprofit basis of the cooperative model. Dividends from retained earnings are the profits that accrue to investors for the capital invested and not as a rebate for purchased goods and services. If the Commission established a fictitious label by calling a portion of telephone cooperative patronage capital "retained earnings," as in the proposed new accounts, it would put the cooperative patron's capital at risk, contrary to cooperative law.

B. Relevance of Tax Exemption

Some telephone cooperatives are tax-exempt under Section 501(c)(12) of the Internal Revenue Code ("Code"). Others may have chosen to forego their tax-exemption and are subject to tax rules and case law that preceded the enactment of Subpart T of the Code (Sections 1381-1386) in 1962.[4] In either case, they enjoy a significant tax advantage that directly bears on this proceeding.

Both exempt and taxable cooperatives must pay patronage dividends of their income over their costs, either in cash or by allocation (which becomes patronage capital) for later distribution. Failure to do so results in loss of cooperative status. Thus, as seen in the Chibardun proceedings, patronage dividends are required by the cooperative's bylaws. Consistent with the non-profit cooperative model, the tax law either grants a full tax-exemption under § 501(c)(12) of the Code or permits a deduction for paid or allocated patronage dividends. Effectively, then, cooperatives are able to retain their surplus as pre-tax capital.

In contrast, a regular corporation can only accumulate retained earnings on an <u>after-tax</u> basis. Thus, co-ops enjoy a significant economic advantage in building capital. To permit telephone cooperatives to use their special tax status to subsidize out-of-territory

[4] Section 1381(a)(2)(C) specifically excludes rural electric and telephone cooperatives. They are taxed as ordinary corporations but are permitted to deduct margins to the extent allocated to members. Rev. Rul. 83-135, 1983-2 CB 32. Effectively they are taxed only on non-patron business.

telephone service, cable television or other competitive services would be inconsistent with the intent of § 196.204(1) and would create an unlevel competitive playing field.

While co-op members must take patronage dividends into consideration for income tax purposes even though not received currently in cash, for most customers, the dividend is not taxable because it represents a refund of a non-deductible personal expense. In contrast, a distribution of true retained earnings is subject to a second level of taxation when distributed.[5]

In the end, the Commission should not create accounting rules which will allow cooperatives to use pre-tax dollars to create or subsidize businesses to compete with businesses created with after-tax dollars. Yet that is what the cooperatives' proposed accounting rules would do.

C. The Proposed Accounts are Confusing

The descriptions provided by the proponents for creating new Accounts 4550.1, 4550.2 and 4511 in prior filings are very confusing. Effectively, they could result in virtually the entire capital structure being classified as retained earnings.

Proposed Account 4550.1 "Retained Earnings – Patronage Capital Unassigned" is defined as "undistributed and unassigned balance of retained earnings from operations of the cooperative and from all other transactions not includible in the other accounts appropriate for inclusion of equity". First, it is immaterial whether surplus is unassigned if it is legally patronage capital. Second, there is no guidance to determine what "transactions" are appropriately "not includible" in equity accounts.

[5] Shareholders of "S" corporations and members of LLCs include the income on their personal returns and are not subject to a second level of tax when distributed. Unlike for cooperative members, however, the allocated income is always taxable.

A similar problem exists for proposed Account 4550.2, "Retained Earnings - Patronage Capital Assigned." The proposal describes it as including "the undistributed and assigned to members of retained earnings derived from operations . . . designated or set-aside for the further development and advancement of the cooperatives' business purpose." Yet while titled "retained earnings," this account reflects the hallmarks of patronage capital -- that it is set aside and assigned to members.

Proposed Account 4511 "Members Equity" is also flawed. As described, it would only include the par value of issued stock or membership fees. As the Commission knows, par values are normally established as a nominal amount with the balance paid going to paid in capital. Membership fees are also usually nominal or non-existent. The net effect is that all surplus (apparently retroactive to 1988 under the proposal) would be retained earnings even though deemed distributed to the members and paid back as patronage capital.

D. Proper Classification Does Not Adversely Affect Telephone Cooperatives

The Federation's previous filings raise a number of dubious, potentially adverse consequences from the *Chibardun Order*.

The *Chibardun Order's* classification of patronage capital as Account 4520 "additional paid in capital" in no way precludes a cooperative's legal obligation to its members to allocate patronage. Indeed, the Commission does not have such power. It would be directly contrary to Chapter 185.

Telephone cooperatives need not maintain a "second set of books" to comply. For Wisconsin regulatory purposes all that is needed is a reclassification of one account. The telephone cooperatives can classify patronage capital however they like for RUS and tax purposes.

The *Chibardun Order* does not create "permanent capital" and risk loss of cooperative status for tax purposes. As noted above, the Commission does not have that power. Moreover, proper classification reflecting the true nature of patronage capital does not block its use for diversified activities. It just limits the subsidization of such activities with pre-tax capital.

Classification as other than retained earnings has no bearing on the debt equity ratio or status of patron accounts for RUS purposes. Proper classification does potentially limit retained earnings for purposes of Wis. Stats. § 196.204(1). The telephone cooperatives' proposal, however, could make a cooperative's entire capital structure comprised of only retained earnings. The anti-subsidization statute, Wis. Stats. § 196.204(1), permits a telecommunications utility to use only shareholder dollars to subsidize competitive ventures. The utility cannot place ratepayer dollars at risk for such ventures. To the extent that a cooperative's rates include dollars used for non-utility investments, the rates are by definition excessive. [6] In the cooperative setting, the members are both the ratepayers and the shareholders. Subsidization, therefore, should only be permitted with earnings from activities unrelated to the core activity of the cooperative and which need not be allocated to members on a patronage basis.

The Federation argues that the *Chibardun Order* restricts expansion and modernization of rural service and prevents diversification. To the contrary, as discussed above, patronage capital is the source for expansion and modernization for its members. All that is at issue is the ability of a cooperative to subsidize services to non-members.

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[6] See the discussion on non-profit operation, below.

E. Non-Profit Operation

At the heart of cooperative tax theory is the requirement that the cooperative be operated on a non-profit basis. Historically, the purpose of patronage capital and the board of directors' flexibility not to pay out patronage capital immediately in cash has been to allow the cooperatives to have capital on hand, both to reduce its borrowing costs by keeping the cooperative on a sound financial footing and to smooth out potential ups and downs in the generation of margin or the incurrence of losses for the provision of services over a number of years. The profit incentive has never been part of that calculus. Indeed,

> the profit incentive [which is] the mainstream of commerce . . . is the antithesis . . . of the cooperative principle [which] requires its services to be performed for the cooperating members . . . . In a cooperative association, the concept of profit is inappropriate because profit, in its recognized economic sense, is the wage of the entrepreneur, and in a cooperative, there is no entrepreneur. A cooperative is 'run for the benefit of those who do business with it and not for the purpose of making profit for the organization.'

50 ALR 435, 442.

Despite that, Wisconsin cooperatives are here requesting that the Commission provide them with a profit incentive. Specifically, if patronage capital is to be considered retained earnings, then those retained earnings would be eligible for subsidizing the activities of for-profit, non-cooperative subsidiaries. If the cooperatives wish to engage in this type of activity, they should reconstitute themselves as for-profit corporations and operate under the same rules as other telecommunications utilities.

If the Commission allowed cooperatives to use their non-profit status to fund competitive business ventures, the Commission would violate basic legal restrictions on the business activities of cooperatives. These restrictions are in place to protect the cooperative ratepayer/member. An analogy is the Unrelated Business Income Tax applicable to tax-exempt organizations using their special tax status to compete with for-profit businesses. *See* Sections 511-514 of the Code. Such tax-exempt, non-profit organizations are not freely allowed to create for-profit subsidiaries, even if the profits from those businesses ultimately serve the mission for which the non-profit parent was originally granted tax-exempt status. Thus, just as the United Way could not use donations to create a for-profit subsidiary selling soap so that the soap profits could be used for United Way charities, a telephone cooperative should not be allowed to use pre-tax patronage capital to create for-profit entities, even if the cooperative's ratepayers/members might benefit from the competitive venture. Whether or not the venture would pay off is not the issue. They are not a proper use of patronage capital, and they are antithetical to the special treatment cooperatives enjoy under the Code.

F. Capital Structure

As part of the basic regulatory compact which has historically guided the development of regulated utilities, a particular entity is granted a monopoly service territory in exchange for a commitment to provide reasonable and adequate service at regulated rates. As part of its duty to ensure the reasonableness, reliability and appropriateness of the rates of regulated utilities, the Commission has historically been concerned with the utility's capital structure. Having a sound capital structure supports the financial strength of a utility and has a direct impact on its cost of capital, a cost which directly affects its rates. Wisconsin statutes explicitly acknowledge the authority of the Commission to determine a "level of equity" that is "appropriate for the utility's capital structure." *See* Wis. Stats. § 196.52(8).

The Commission has not historically set an explicit level of equity for telephone cooperatives, as it has from time to time for other telecommunications utilities. *See, e.g., Notification by Forestville Telephone Company, Inc. That It Intends to Increase Telephone Rates*, Docket No. 2050-TR-101 (1994) ("*Forestville*"). In fact, there has been no need to. A cooperative's bylaws, which require it to operate on a non-profit basis and to treat any margin (that is, the amount of revenues generated in excess of the amount of costs for providing the utility's service) as patronage capital, with all the appropriate bylaw restrictions on the use of patronage capital, has itself provided adequate assurance that a cooperative's capital structure would support reasonable and reliable service at appropriate rates.

If the accounting changes proposed by the cooperatives are adopted, however, that situation will change. Rather than keeping patronage capital within the cooperative, management would be empowered to invest profits generated from the utility's service into unregulated ventures. The result could be an undercapitalized utility.[7] Such undercapitalization would put the core services of the cooperative at risk.

As the REA bulletin states, patronage capital is the real base capital for a cooperative. The typical cooperative has little in the way of equity capital. In contrast, the base equity of a non-cooperative is significant, needs only be returned to shareholders upon liquidation of the enterprise, and retained earnings only result if the equity is successfully utilized in the business.

In sum, classifying patronage capital as retained earnings could jeopardize a cooperative's mission. Because true equity capital in a cooperative is generally so small, under the cooperatives' proposal everything else in a cooperative's capital structure could be labeled as "retained earnings" for purposes of Wis. Stats. § 196.204(1). This could not only nullify the statutory cross subsidization protections, but it could also endanger the economic viability of the core function of the cooperative of providing services first to its members.

[7] In determining a utility's capital structure, any subsidies provided to non-regulated affiliates would not be considered equity, as the Commission would "remov[e] non-utility assets directly from total common equity. The

III. Effect on Competition

If the proposed accounting rules are adopted, the affect on competition will be direct and detrimental to the interests of Wisconsin residents. In short, all the cooperatives in the state could follow Chibardun's example. That is, they would use their pre-tax profits generated from monopoly utility services that belong to their ratepayers/members to create subsidized non-cooperative and non-utility entrants in competitive fields. In other words, the proposed accounting rules would create a privileged class of competitor, for no legitimate public policy purpose.

Particularly vexing is the claim put forth by the cooperatives in support of legalized utility subsidization of competitive, non-utility business ventures that the subsidization is required to bring advanced services to the rural areas. Nothing stops the cooperatives from bringing advanced services to their ratepayers/members by investing in their own service territories. The notion that cooperatives are doing a favor of customers in the service territories of other incumbents is false. Chibardun and other cooperatives have targeted CenturyTel service territories for competitive entry, where CenturyTel is already investing millions of dollars to improve former ILEC systems and deliver advanced services. As the Commission has seen in the case of Telephone USA, the impact of unfair competition on the incumbent and its remaining customers is severe.

The Commission has a unique opportunity in this case to establish policy that will determine whether there will be fair conditions for competition in Wisconsin's rural telecommunications markets. The Commission resolved this issue correctly the first time, ruling

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removal of non-utility investments from total common equity is consistent with the Commission's treatment of such items in recent rate decisions of other utilities." *See Forestville*, slip op. at 14.

that cooperative patronage capital is not retained earnings and therefore cannot be used to subsidize competitive ventures. The Commission should hold firm, as its policy ensures fair competition. To do otherwise would encourage unfair competition. The Commission should not create the conditions where incumbents will be forced to abandon exchanges altogether when overrun by under-priced, subsidized services offered by cooperative subsidiaries. In rural areas, there is a particular risk that the highest cost customers could be left without affordable service.

Dated this 1st day of October, 2002.

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By ______________________

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05-US-115

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WISCONSIN PUBLIC SERVICE COMMISSION

VIA HAND DELIVERY

Ms. Lynda L. Dorr, Secretary
Public Service Commission of Wisconsin
610 North Whitney Way
Madison, Wisconsin 53707

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives; Docket No. 05-US-115

Dear Ms. Dorr:

Please find enclosed for filing an original and fifteen copies of the Comments of Wisconsin Cable Communications Association in the above-referenced matter. Please file stamp the additional copy and return to our courier for our files.

Thank you for your assistance in this matter. Please contact me if you have any questions regarding this matter.

Very truly yours,

David G. Walsh

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Enclosures
cc: Thomas Hanson

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BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Accounting Treatment for Patronage Capital by Telecommunications Cooperatives	Docket No. 05-US-115

<u>COMMENTS OF WISCONSIN CABLE COMMUNICATIONS ASSOCIATION</u>

The Wisconsin Cable Communications Association ("WCCA") submits these comments to the Public Service Commission ("Commission") of Wisconsin's investigation "to determine the appropriate accounting treatment for patronage capital by incumbent local exchange carrier ("ILEC") telecommunications cooperatives." Specifically, the Commission is investigating whether changes should be made to the USOA to adopt two new sub accounts, 4550.1, Retained Earnings – Patronage Capital Unassigned, and 4550.2, Retained Earnings – Patronage Capital Assigned and to create a new account 4511, Members Equity, and if so, the effective date of any such changes.

The proposed change is in response to the Commission's decision in "Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations, Docket 1090-TI-100 (November 16, 2001) ("Chibardun Order"). The Chibardun case was initiated by the "Petition of Marcus Cable Partners, LP ("Marcus") for The Investigation Of Chibardun Telephone Cooperatives, Inc. and CTC Telcom, Inc. dated October 31, 1997. Marcus' Petition alleged that Chibardun Cooperative, Inc. ("Chibardun") subsidized its subsidiary CTC Telecom, Inc. ("CTC"), in an amount greater than its retained earnings in violation of Section 196.204 (1). In addition, Marcus alleged that Chibardun together with CTC violated CTC's ATU Order which prohibited Chibardun from subsidizing, directly or indirectly, any unregulated activity of CTC. Likewise, the CTC ATU Order also prohibited CTC from receiving any subsidies, direct or indirect, from its parent, Chibardun (see "Second Interim Order" of August 6, 1997). By Order dated January 28, 1999, the Commission issued its formal notice of proceeding and investigation designating the matter a class 2 contested case. On February 21, 2000, the Commission granted Marcus' motion to intervene. The Commission issued its Amended Notice of Proceeding, on March 30, 1999. The class 2 contested case involved a number of issues.

The issue pertinent to this docket, was whether Chibardun's subsidies to CTC violated Section 196.204 (1). Chibardun's primary defense was that Section 196.204(1) allowed it to subsidize its subsidiaries to the extent of its retained earnings and the calculation of retained earning should include patronage capital. The Commission held that patronage capital is not a part of retained earnings and it should be properly accounted for as "additional paid in capital."

The cooperatives are now asking the Commission to adopt new accounting rules to reclassify patronage capital as a part of retained earnings. The Wisconsin Federation of Cooperatives marches forward with a litany of unproven allegations why a change is appropriate. These include a number of unsupported allegations that we assume will be addressed and supported by its comments, to which we will respond.

The Commission has listed a number of issues in its notice of investigation. Before providing specific comments, the WCCA respectfully offers the following general comments.

This matter is not about what the cooperatives describe as a fatal blow to their efforts to diversify. Rather, this issue is about whether there will be a level playing field in the landscape of telecommunications competition in the State of Wisconsin. The history of Chibardun case bears this out. It was commenced by a cable television operator who was confronted with a competitor who was aggressively subsidized by its parent. The subsidy was so extensive that it included a guarantee of all financing, use of trucks, equipment, facilities, computer programs and common names ("CTC"). Even to this day, the Chibardun subsidiary has no employees. What had greater impact, however, was that the subsidiary-competitor charged prices significantly below standard prices in the industry. Marcus provided Commission staff with information demonstrating that the prices charged by the competitor after reasonable expenses could not possibly amortize the cost of construction. The fact was that Chibardun so clearly subsidized its subsidiary that rather than creating competition there was a possibility there would be no competition. The Chibardun case was about a non-profit cooperative taking advantage of its nonprofit cooperative status to accumulate and retain its patron's capital which it used to subsidize a competitive entry against a cable television system. It is disingenuous, indeed hypocrisy, to suggest that a Commission Order that appropriately defines patronage capital will result in a litany of horribles. The cooperatives can claim what they want but the Commission's decision was correct. That decision does not preclude Chibardun from competing fairly in the marketplace. Rather, it merely holds that if a cooperative wishes to take advantage of its cooperative status, it may not use the funds (that it is required to return to its patrons in order to retain its status) for resources to subsidize a competitive entry in a non-regulated marketplace. The issue is to what extent should a public utility be allowed to subsidize competitive entrants in the marketplace. The cooperatives attempt to use their patrons' capital as additional resources to subsidize nonregulated activities is unfair, contrary to the historic regulatory compact by which the cooperative utilities have been granted monopoly status, and a breach of their own bylaws upon which they rely for their tax-free status. Moreover, it is bad public policy.

The WCCA offers the following comments to the specific issues listed in the notice of investigation.

1. Whether the Commission's patronage capital accounting directives as it concerns accounts 4520, Additional Paid-in Capital, and 4550, Retained Earnings, and its interaction with Wis. Stat. § 196.204 addressed in the Chibardun Order should be extended to all ILEC telecommunications cooperatives, or a portion thereof. If not, whether the Commission's Chibardun Order concerning patronage capital accounting should be rescinded.

The Commission's patronage capital accounting directives addressed in the Chibardun Order should be extended to all ILEC telecommunication cooperatives. As noted by the Commission, the bylaws of each of the cooperatives include the same language found in the Chibardun case wherein patronage capital is defined as having "the same status as though paid to the patron in cash in pursuance of a legal obligation to do so and the patron has then furnished the cooperative corresponding amounts for capital." Accordingly, the conclusion is inescapable. Patronage capital is not retained earnings. Indeed, when the bylaws address retained earnings, they specifically distinguish it from patronage capital (see 2 below). The cooperatives cannot have it both ways. They may not accumulate patronage capital which no one disputes belongs to the patrons based upon their respective use (unlike a for-profit corporation which holds accumulated earnings on a per share/ownership basis), and then without any control or regulation use it to subsidize risky investments.

The Chibardun Order concerning patronage capital accounting should not be rescinded in this proceeding. Chibardun and Marcus were parties to the Chibardun Order. The Chibardun Order cannot be rescinded without due process accorded each of the parties.

2. Whether the language in the respective ILEC telecommunications cooperative's bylaws influence in any way and, if so, to what extent, the accounting treatment to be accorded to patronage capital.

The cooperatives' bylaws are a contract by and between the members and the legal entity. As such, they define the use and allocation of funds including patronage capital.

They are the best definition of patronage capital and the accounting treatment to be accorded it. The bylaws specifically provide that patronage capital belongs to the patrons, not the cooperative and that the cooperative merely holds the funds as if the patrons had furnished corresponding amounts for capital. Moreover, the bylaws specifically note that "[a]ll other amounts" received from non-regulated or non-operating income, shall insofar as permitted by law: "Be reserved as unallocated retained earnings, and shall not be allocated to the Cooperatives' patrons on a patronage basis as part of the capital credited to the accounts to the patrons" and may be "used for business purposes as determined by the Cooperative." It could not be clearer that the bylaws specifically distinguish between what is commonly referred to as "retained earnings" which may be "used for business purposes as determined by the Cooperative" and "patronage capital" which will be treated as "though paid to the patron in cash" and furnished to the Cooperative by the patron for capital. Accordingly, as the bylaws note, patronage capital should neither be considered retained earnings nor used as retained earnings.

3. In what respects similarities between ILEC telecommunications cooperatives and for-profit ILECs should influence, if at all, the accounting treatment to be accorded to patronage capital.

The similarities as well as the differences between ILEC telecommunications cooperatives and for profit ILECs should influence the accounting treatment to be accorded patronage capital. The similarities should influence the determination because as an ILEC telecommunication cooperative departs from its traditional role of a monopoly marketplace provider it relies upon a corporate structure similar to a for profit ILEC and therefore must accept the restrictions imposed upon the for profit ILEC and in particular a retained earnings limit on subsidies. Likewise, the distinction between an ILEC telecommunication cooperative, which is obligated to return patronage capital to its patrons on a usage basis, and the for profit ILEC which holds its undistributed profit (margin in the case of a cooperative) is clear. The for-profit

ILEC has no obligation to return the funds to its shareholders on a usage basis. This is conclusive as to the accounting treatment to be accorded patronage capital. The distinction speaks for itself. Patronage capital is not retained earnings.

4. What relevance Wis. Stat. Ch. 185 should play in the accounting treatment to be accorded to patronage capital.

Wisconsin Statute Chapter 185 provides further support that patronage capital should not be considered or allowed to be used as retained earnings. Section 185.45(3) describes that unless the articles or bylaws otherwise expressly provide, the net proceeds (also referred to as margin) shall be distributed and paid to the patrons. This requires a treatment of patronage capital which is different than retained earnings. The bylaws of the cooperatives examined by the Commission are consistent with Section 185.45(3), which clearly creates a distinction from retained earnings. The proposed accounting rules are an end-around the requirements of this statute.

5. Whether the treatment or consideration accorded to patronage capital by other governmental agencies (e.g., RUS), via legal requirements (including court cases or other directives) or external lenders influence in any way and, if so, to what extent, the accounting treatment to be accorded to patronage capital.

Treatment accorded to patronage capital by other governmental agencies, legal requirements or external lenders should be reviewed in determining the accounting treatment to be accorded patronage capital. While the bylaws are certainly the best evidence of the legal contract between the patrons and the cooperative, court cases and directives are of assistance in determining the contractual relationship. On the other hand, external lenders should have significantly less influence. This applies equally to governmental financing entities.

Moreover, the core of business of the cooperatives is significantly better protected by treating patronage capital as additional paid-in capital. This is because it provides additional stability and security for the financing of the core business. At the very least, this once again emphasizes the risk of an underfunded subsidiary requiring significant subsidies from its parent.

6. Whether the Commission's accounting treatment of patronage capital has any impact, whatsoever, on the ILEC telecommunications cooperatives' nontaxable status for either federal or state income tax purposes.

The Commission's accounting treatment of patronage capital may have an impact on the ILEC telecommunications cooperatives' tax status. The issue is whether an ILEC telecommunication cooperative's patronage capital can be used to subsidize a subsidiary's entry into a non-regulated marketplace. To the extent the non-taxable status relies upon a percentage of revenue from regulated or non-regulated activities, if the Commission defines patronage capital (which is the margin from regulated activities) as being part of retained earnings, that may change the calculation of the regulated and non-regulated revenue, which in turn may impact a cooperative's tax status.

7. Whether the Commission should adopt two new subaccounts 4550.1, Retained Earnings-Patronage Capital Unassigned, and 4550.2, Retained Earning-Patronage Capital Assigned, and create a new account 4511, Members Equity.

The Commission should not adopt the two new sub-accounts. Adopting the accounts would result in nearly the entire capital structure being classified as retained earnings. Also, the terms are confusing and who is to determine what is assigned and unassigned? Moreover, the Commission has the history of carefully examining what is behind the accounts and capital structure (see also 191.52(8)). The Commission has removed non-utility assets from total common equity (see e.g., Notification by Forestville Telephone Company, Inc. That It Intends To Increase Telephone Rates, Docket Number 2050-TR-101 (1994)). The mixing of patronage capital and retained earnings raises the same issue and should not be allowed.

8. If patronage capital-related amendments to the USOA are adopted, what should be the effective date of any such changes. If not adopted prospectively, whether any particular past date(s) should be utilized.

Whatever new rule is adopted should be adopted prospectively. The Chibardun case was commenced five years ago. These issues are not new. The cooperatives have been on notice. The only reason to adopt a rule retroactively would be to "immunize" previous subsidization activities that violated Wisconsin Statute Section 196.204(1). This would be inappropriate.

Dated this 1st day of October, 2002.

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